The ECB and the Betrayal of the Bagehot Rule

Mario Seccareccia - 12/08/2015 [papers]

Abstract

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There has been much discussion in the media about the Greek crisis, but the role of the European Central Bank (ECB) has been very much downplayed and has often been presented as an arm's length institution that is above all suspicion, whose main objective has been merely to stabilize the Eurozone monetary and financial system. Indeed, the ECB has been celebrated as the most "independent" of central banks. However, as it is well known, it is actually more accurate to say that the ECB is a supra-national central bank that stands as the supreme technocratic authority that is supposed to act in the public interest without, we are told, favouring any one national government or group of national governments. The ECB directs *ex cathedra* within a specific policy framework the whole constellation of national central banks in the Eurozone, with the latter national central banks being merely subsidiaries of the ECB within the overall European System of Central Banks (ESCB). National central banks are thus "independent" of their national governments but, at the same time, completely dependent vassals of a higher and presumably "neutral" and "rules-based" technocratic authority, the ECB that ought to regulate and conduct policy in order to achieve the goals set out in its original mandate, that is, to achieve price stability and the maximum level of welfare within the whole Eurozone, without prejudice or partiality. However, as stipulated in the Maastricht Treaty (as well as in the Treaty on the Functioning of the European Union (TFEU)) that established the basic hierarchical monetary structure of the European Economic and Monetary Union (EMU), according to Article 105 of the Treaty (or Article 127 of the TFEU) one of the most basic tasks of the ECB was "to promote the smooth operation of payment systems" within the respective member countries of the Eurozone. The maintenance of a viable payments system is of crucial importance to the operation of an advanced market economy in which bank deposits are important substitutes for the all-important ultimate liquid asset in times of crisis, namely the central bank's liability. There exists a critically important principle of central banking that has evolved over the last two centuries as central banks appeared in part to deal with systemic banking crises. For instance, in the United States the Federal Reserve System was founded in 1913 as a result of the disastrous financial panic of 1907 to fulfill the important function of lender of last resort. One of the very basic principles associated with this role of lender of last resort is sometimes referred to as the Bagehot Rule for the smooth functioning of the payments system. In *Lombard Street: A Description of the Money Market*, published during the financial panic and collapse of 1873, Walter Bagehot suggested that the Bank of England should "quickly, freely and readily" advance liquidity at an appropriate rate of interest (which he considered ought to be a "penalty" rate) to all struggling commercial banks in search of liquidity on the basis of sufficient collateral, as the latter would be valued as good in "ordinary times". To stave off a bank run that can degenerate into a collapse of the complete payments system, Bagehot's doctrine advises how central banks should react by lending to what may be deemed as solvent, yet illiquid, commercial banking institutions. Such a basic principle is at the heart of modern central banking. The problem, of course, is that it is not always easy to distinguish insolvent from illiquid banks. But that is the art of central banking, which, among other things, is to know how to recognize and distinguish these two often related, yet distinct, types of situations. This whole question of distinguishing bank insolvency from banking sector liquidity needs has manifested itself recently and has become a problem with respect the recent legalistic position taken by the Governor of the ECB, on July 16, 2015, in defense of the

latter`s non-accommodative role vis-à-vis the liquidity needs of Greek banks, based on Article 18.1 in the ECB Statute. The Article states that: "In order to achieve the objectives of the ESCB, the ECB and the national central banks may conduct credit operations with credit institutions and other market participants, with lending based on adequate collateral." His *de facto* interpretation that Greek banks were essentially insolvent (rather than illiquid) appears to be somewhat of a distortion of the role of central banks as purveyors of liquidity, since the notion of "adequate collateral" in the Bagehot sense also require that this collateral be valued by central banks not at "fire sale" values of the respective distressed banks but at "normal" values that would exist at "ordinary times". Surely, the liquidity problem faced by Greek banks was not some sudden random outcome of bad management by Greek banks but primarily the result of a systemic crisis arising from an intense public demand for liquidity. This point pertaining to this tortured interpretation of the Bagehot Rule by the ECB also has been recently raised by other commentators. As is well known, this lender-of-last resort function was important during the thick of the financial crisis of 2008 internationally. While the triggering mechanism was the problem of insolvency of a number of financial institutions in 2008, the freezing up of the interbank bank market for funds after the collapse of Lehman Brothers in the US quickly transformed a problem of insolvency into one of liquidity upon which central banks internationally acted according to the Bagehot Rule. This happened also in the Eurozone. The ESCB aborted a collapse of the banking sector in certain countries during the international financial crisis as well as following the crisis, as depositors in some countries of the Eurozone fled to "safer" havens, particularly after 2009 as the crisis intensified and metamorphosed into a sovereign debt crisis. However, this was not the classic crisis as immortalized in Jimmy Stewart's *It's a Wonderful Life* depicting the US banking crisis of 1933, since it was primarily a transfer of deposits from the "unsafe" centres of southern Europe, such as Spain, to the "safer" centres of northern Europe, such as Germany and Luxemburg. Hence, as the depositors withdrew their funds from commercial banks in Spain, the Banco de España would advance liquidity to these Spanish banks facing a liquidity drain in favour of banks in Germany. Unlike countries where there is one national central bank and not the hierarchical institutional layers of central banks to be found in the Eurozone, these interbank movements of funds were recorded as Target2 imbalances, whereby the advances from the Banco de España would be accounted as negative Target2 balances and those of its counterparty at the Bundesbank as positive Target2 settlement balances. This peculiar institutional application of the Bagehot Rule in the Eurozone is displayed in Figure 1 below, which depicts the evolution of these counterparty balances for only six countries since 1999 and which also highlights the fact that this drain of funds from southern Europe peaked when Mario Draghi declared in 2012 that the ECB would do "whatever it takes" to defend the Euro because of the potential purchases arising from the implementing of the Outright Monetary Transactions (OMT) policy commitment. This policy, which sought to prevent a cumulative drainage or flight of speculative deposits from southern Europe, did work initially with the narrowing of the Target2 balances. But as can be seen in Figure 1, these balances began to rise somewhat once again as the election of Syriza in Greece approached by the ... he German

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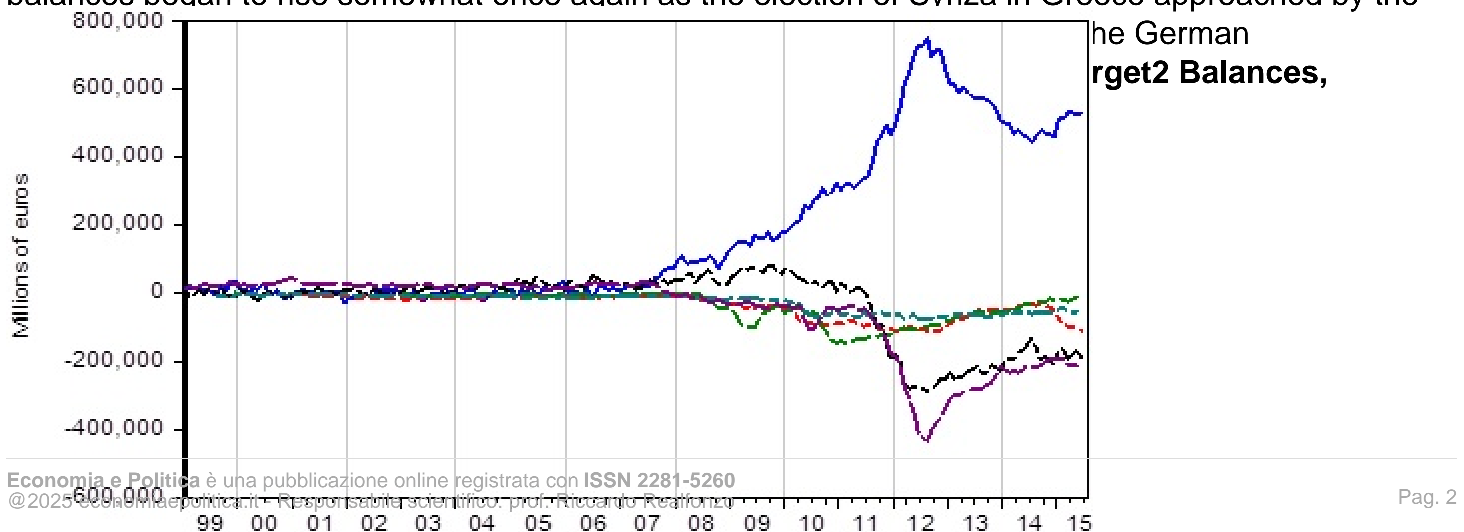

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www.eurocrisismonitor.com) But what did the ECB do? Coinciding with the Greek election, in January 2015, it began its policy of quantitative easing (QE) which, as any well-informed economist knows, does practically nothing to stimulate the economy except if one believes in some defunct monetarist theory that the causal structure of the transmission mechanism of monetary policy goes from changes in base money to changes in bank lending. However, what QE does do is to flood the banking sector with liquidity, via the purchase of government securities, and potentially impact on the level and structure of interest rates within the Eurozone. The effect of this growth in banking sector liquidity would be to mitigate somewhat the build-up of Target2 balances that would have otherwise exploded as they had before 2012. However, instead of being a "neutral" player, from the beginning of the QE operations, the ECB selectively discriminated against the purchase of Greek bonds. What has happened since the Greek election in January is now relatively well known, since Greek banks had been relying more and more on emergency liquidity assistance from the ECB that was eventually cut off at the end of June 2015. Hence, what we witnessed since the election of Syriza was the continued transfer of deposits as it had already occurred before 2012, as reflected in the expanding Target2 balances, together with the compounding effect of a more perilous drainage of liquidity from commercial banks in Greece in the more classic sense imagined by Bagehot and Keynes arising from a strong preference for cash as, for instance, it had occurred in the US in the 1930s, which led to the famous "Banking holiday" of March 1933 under President Franklin Roosevelt to prevent the complete collapse of the US banking system. However, in the Greek case, this was largely triggered and most certainly compounded by the political maneuvering of the ECB itself, which forced the banking collapse after the Greek referendum at the beginning of July 2015. Already before the breakdown of the negotiations between Greece and the Troika, on June 18, 2015, the ECB had been telling Eurozone finance ministers that, with the massive hemorrhage and deposit outflow from Greek banks, the latter might not even be able to open their doors to the public on the following Monday, June 22! It is difficult, if not inconceivable, to fathom how representatives of the ECB would allegedly be leaking out such incendiary statements to the media in the midst of negotiations if it were not to create a state of frenzy in Greece even before the collapse of the talks. Be it as it may, on June 24, 2015, it is well known that the Tsipras government rejected the terms put forth by the Troika for a new loan to allow the government to roll over the payment of €1.55 billion owed to the IMF. In a strategic move to strengthen its hand in future negotiations, the Greek government announced a referendum over the terms set forth by the European Commission, which led to a massive rejection of the austerity measures on July 5, 2015, even though Greece's membership in the Eurozone was never explicitly or officially at issue in the Greek referendum, despite some of the recent uproar about setting up a parallel currency (the so-called Plan B of the former finance minister, Yanis Varoufakis. Confronted with a refusal by the Germans and other hardline members of the Eurozone, including a lack of solidarity from those leaders of governments in southern Europe, such as Spain, who were fearful of their own political vulnerability domestically, the Greek government did a political *volte face* and accepted the terms of the European Commission, which were actually even more punitive than those that it had previously rejected on June 24. However, one important element that played out both politically and financially was the rather pernicious behaviour of the ECB itself. As soon as the Greek government refused the initial austerity package and announced that the referendum would be held, the ECB refused to increase its liquidity assistance, even though it knew fully well that this was not primarily because of a solvency problem for Greek banks but overwhelmingly it was a *systemic liquidity* problem arising from the growing uncertainty and fears on the part of the public reflected in the progressive hoarding of liquid funds. This fear was undoubtedly compounded by the actions of the ECB itself, which offered the Tsipras government no choice but to shut down the banks, impose capital controls and restrict individual withdrawals to €60 per day. Hence, instead of seeking to support and promote the smooth operation of the payments system of one of its member states that, at no time, had officially proposed exit from the Eurozone (in fact, it was the German leaders who

were strategizing a “temporary” Grexit), the ECB actually cut off its liquidity assistance deliberately in order to destabilize further the Greek payments system and force the Syriza government into accepting the harsh austerity measures. It is interesting that once the Greek parliament accepted the terms of the austerity package, the ECB not only resumed its liquidity assistance but, for the first time, extended QE purchases to Greek government securities! Ironically the emergency funds freed up by the European Commission were then used to make Greece’s scheduled payment of €3.5 billion to the ECB on July 20, 2015. These were funds that we know the ECB did *not* “need” since, at the same time, the ECB was showering the rest of the Eurozone with €1.08 trillion QE purchases of government securities in its original timeline declared in January 2015 (or some €60 billion in purchases per month). Clearly the ECB played a cruel political game of destabilizing the Greek economy to further the ends of the current political and technocratic elite of the Eurozone. The result has been not only a denial of democracy via its flagrant financial interference that sought to strengthen the hands of the hardline “austerians” in Europe, but, it may be said, it also acted in contravention of the Bagehot Rule of providing liquidity so as “to promote the smooth operation of payment systems” (as stipulated in its charter) in one of its struggling member states by imposing unwarranted financial hardship on the people of Greece. Hence, contrary to the ECB tortured interpretation of its own statutes, the ECB failed to exercise its crucial role as a central bank, namely that of purveyor of liquidity during the Greek banking crisis. As many observers have stated it, one of the obvious casualties of this abuse of power has been democracy in Europe. However, one other casualty that has not been mentioned is the notion of central bank “independence” in the Eurozone, which has now also become a hollow cliché.

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