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A lender of last resort on trial: Remarks on the controversy surrounding the role of the European Central Bank in the financial crisis

The recent European debt crisis has generated a growing importance of the European Central Bank (ECB). The ECB was forced to take measures far beyond its traditional role to stabilize monetary markets and inflation. The ECB has adopted a new function as a lender of last resort, providing banks and governments with almost unlimited liquidity and purchasing government bonds within Outright Monetary Transactions (OMT). This new role of the ECB has been hotly debated. In Germany, the debate even reached the Constitutional Court. The article will give a survey of the fundamentals of a lender of last resort and of the debate referring to the arguments of the ECB and Bundesbank. It is indeed questionable whether the ECB has a mandate for its new monetary and *nolens volens* fiscal role. Regardless of whether the arguments are convincing, new steps towards new fiscal arrangements and a banking union are needed to stabilize the euro area.

Keywords: European Central Bank, lender of last resort, Outright Monetary Transactions, European fiscal union

JEL classification: E52, E58, F55

Pożyczkodawca ostatniej instancji przed sądem. Uwagi na temat kontrowersyjnej roli Europejskiego Banku Centralnego w kryzysie finansowym

Niedawny kryzys zadłużeniowy w Europie przełożył się na rosnące znaczenie Europejskiego Banku Centralnego (EBC). W celu stabilizacji rynków i inflacji bank ten był zmuszony podejmować działania wykraczające daleko poza jego tradycyjne kompetencje. EBC zaczął pełnić nową funkcję pożyczkodawcy ostatniej instancji, zapewniając bankom i rządom niemal nieograniczoną płynność, a także skupować obligacje rządowe w ramach bezwarunkowych transakcji monetarnych (OMT). Na temat nowej roli EBC toczy się burzliwa debata. W Niemczech miała ona swój finał przed Trybunałem Konstytucyjnym. Artykuł ten przedstawia podstawowe informacje dotyczące pożyczkodawców ostatniej instancji, jak również argumenty EBC i Bundesbanku. Jest kwestią dyskusyjną, czy nowa rola monetarna i – siłą rzeczy – fiskalna EBC mieści się w granicach przyznanych mu kompetencji. Niezależnie od siły perswazji poszczególnych argumentów, stabilizacja strefy euro wymaga podjęcia kroków zmierzających ku wprowadzeniu nowych rozwiązań fiskalnych i unii bankowej.

Słowa kluczowe: Europejski Bank Centralny, pożyczkodawca ostatniej instancji, bezwarunkowe transakcje monetarne, europejska unia fiskalna

Klasyfikacja JEL: E52, E58, F55

Introduction: The Eurosystem and its fundamental issue: What actually is a currency area and how and why does it function (or does it?)

People have been voicing criticism of the fundamental design of the European Monetary Union ever since it came into being. Does it really constitute an optimal currency area? According to Mundell [1961], it is above all the spatial and sectoral mobility of capital and labour that contribute towards optimality. Authors building on the Mundellian basic model speak of sufficiently flexible capital flows in face of asymmetrical shocks, of financial market integration, degrees of openness in trade and, in view of the European-wide migrant crisis, not least of the free movement of individuals.

But let's take a look at the role to be played by a central bank in an optimal currency area. Besides basic questions like the exclusive right to issue money and paper acceptable as collateral, the central bank's role in times of global financial and economic crisis seems uncertain. Clearly, the fathers of the European Central Bank failed to provide sufficient clarity on the division of responsibilities between the Central Bank on the one hand, and fiscal policy on the other.

In a shared understanding of their respective roles, a central bank responsible for the money market coexists with a fiscal policy responsible for the goods and labour markets. Monetary policy does not interfere with relations on the markets for goods and labour; and fiscal policy *vice versa* limits its activities to the goods and labour markets. This is a well-established tradition that also makes good economic sense.

In the current situation, though, this traditional division of roles seems to have become a thing of the past – at least for the time being. In the midst of the crisis, the Central Bank feels it necessary to engage in several fields of action outside its brief: namely, in addition to monetary policy, its actions also impact on the areas of fiscal and income policies. This is perceived to be necessary because other actors have failed to do their work properly, an accusation directed above all at the fiscal policies of nation states.

These interventions are not only contentious from the standpoint of economic policy: they also give rise to serious legal implications. No less an authority than Deutsche Bundesbank referred the matter to the German Constitutional Court. The ECB's Outright Monetary Transactions and full allotment policy, so the complaint, has transcended the borders between monetary and fiscal policy and its original function as lender of last resort only for the banking system. It is in effect pursuing a monetary policy to finance state budgets. This is the crucial point: the commixture of fiscal and monetary policy and, in consequence, a breach of competence of the ECB. In 2014, the German Constitutional Court requested a preliminary ruling from the European Court of Justice (ECJ) and expressed doubts about the legality of OMT under German and EU law. In turn, in June 2015 the ECJ decided against the opinion of the German Constitutional Court, ruling that the European Central Bank was acting within its mandate to safeguard the European currency system.

The controversial debate is by no means over. Following the ECJ's rejection of its opinion, in February 2016 the German Constitutional Court opened a second hearing on the ECB's intention to ban all limits on bond purchases. It is by no means clear what the final decision will be.

In the following, the paper will take a short look at how the modern role of central banks has evolved – starting with Baring's pioneering work on Bagehot's conceptualization of lender of last resort, through the Bundesbank model as the blueprint for a European central bank, up to the controversy surrounding a central bank's mandate in today's world. We pose the question whether, in keeping with the monetary theoreticians surrounding Baring and Bagehot, the European Central Bank should act as a temporary lender of last resort in times of bank runs and financial panic, or whether it has taken on the role of permanent creditor? Can and should there be a restoration of the *status quo ante* once the crisis is over?

1. The art of central banking

It was Ralph George Hawtrey, who in an article published in 1932, titled 'The Art of Central Banking', likened central banking to an art. The 'art' comprised issuing paper based on precious metals deposited with the bank. From this time on, such paper receipts were accepted as means of payment. The holders of such paper enjoyed the right at any time to demand from the respective bank the issuance of an accordant amount of coinage. What at first sight constitutes a simple barter trade was quickly perceived by holders of political power as a way to access financing of public debt – a tempting prospect. The art of central banking lies in the balancing act of resisting and yielding to such temptation [Hawtrey, 2003, pp. 150 ff.].

The Bank of England, frequently called the mother of all central banks, was a case in point. Its most important task was to lend money to the government. Hence, it wasn't long before other central banks were established in Europe, first and foremost with the task of financing state budgets.

What ultimately turns a central bank into guardian of a currency, at home and abroad, is its paternalistic conception of itself as protector of the monetary economy. This ascription is the result of processes of autonomy building in the wake of the modernisation of our payment system, in particular following the introduction of paper money. However, once a central bank begins holding the deposits of merchant banks, in a monetarised world it is just a small step away from standing by their side in the event these investment banks are no longer able to raise sufficient liquidity to meet their obligations *vis-à-vis* the private sector. In this way, in crisis times central banks become lenders of last resort, i.e., in times of financial crisis they provide distressed banks with liquidity in the form of central bank money. In 1797, Francis Baring in his *Observations on the Establishment of the Bank of England* wrote of the need to make provisions for the event that it would come to a sell-off of debt-financed real and illiquid assets in favour of holding money. There should be a *dernier resort*, an ultimate responsibility in the event of a run on a bank [Baring, 1967, p. 22]. Five years after the publication of Baring's *Observations*, in 1802 Henry Thornton pointed out that a monetary court of appeal according to French law may be just the sort of *dernier resort* [Kindleberger, 2001, p. 207] capable of preventing contagion of the type caused when investment banks experience a liquidity crisis. A bank anywhere going bankrupt could lead to a general run on other banks [Thornton, 1939, p. 180].

Baring's idea was not to entrust this task to any type of treasury, but rather to empower central banks to grant unrestricted credit on the basis of sound collateral. By so doing, he created that special central bank status that was to make them a bastion in times of monetary crisis. Some 70 years after Thornton, Walter Bagehot followed this up in his ground-breaking paper *Lombard Street*. Central banks should act as the lenders of last resort not in order to rescue insolvent debtors from the bankruptcy made inevitable by their excessive indebtedness, but rather to come to the aid of albeit illiquid but basically solvent borrowers. Those are the persons to be rescued, against deposits of sound collateral instruments that means on all good bank securities 'as largely as the public ask for them'. These loans should only be made 'at a very high interest' and in face of the otherwise costly pledging of such instruments. The lender of last resort may be expected to resist 'unreasonable timidity' and would at the same time 'prevent the greatest number of applications by persons who do not require it' [Bagehot, 1874, pp. 102–103]. The famous Bagehot rule was born.

With these basic rules for exercising the function of lender of last resort the central bank became a guardian of the currency guided by a paternalistic self-conception.

Compared with the English national bank, it took much longer for the German central bank to develop into a politically independent and autonomous institution. Moreover, the German perception of what a central bank should be was shaped by external influences. On the one hand, in view of unfulfilled reparation claims after the World War I the allied powers exerted pressure to have the Reichsbank removed from direct government control and placed under an independent Reichsbank Board of Directors. After the World War II the allies again intervened, calling for the centralist federal reserve system to be broken up and replaced by a 'Bank deutscher Länder' (Bank of German states). Then, in 1957, they pressed for the Bundesbank Act that was to become a role model for central banks' independence. With the new Deutsche Bundesbank Act, the central bank of Germany was given a structure that survived until its integration into the system of European central banks. Since it was founded, the political consensus concerning the Bundesbank's self-conception has ensured the high degree of autonomy and incontestability that contributed towards its near-mythical status. Thus, the Deutsche Bundesbank – born out of the trauma of two world wars, political manipulation, and inflation – bases not only on the regulative logic of monetary control, but equally from a socio-psychological point of view resulting from the collective experience of the German people [Tietmeyer, 1996, p. 32].

2. Unconventional monetary policy in crisis times

The early years following the founding of the ECB were accompanied by a deceptive calm. This was mainly because the European currency union was entirely in accordance with ideas of what should constitute an optimal currency area and therefore initially met with homogenous conditions on financial markets with correspondingly low and homogenous costs of financing. Stable, efficient, and sufficiently interest-elastic capital markets did indeed initially provide for a smooth transmission process in monetary policy.

By the outbreak of the crisis, though, it had become evident that the growing asymmetries among the market players were no longer tenable. The Sachverständigenrat (German Council of Economic Experts) described the process as a cascading decline in the value of assets [SVR, 2008/2009, par. 173]. Financial market integration was stalled as capital flows in the eurozone were reversed. Due to the destabilizing and self-reinforcing interdependencies between deteriorating public finances, a severe economic recession and fragile bank balance sheets, some countries began to experience the effects of a negative feedback loop between budgetary, real-economy, and financial developments.

There was no plausible or efficient safety mechanism. It took far-reaching boosts to liquidity and cuts in interest rates on the part of the national central banks to ensure that other banks were able to meet their payment obligations, in a situation where the interbank market had ceased to function. Governments had the task to find solutions for banks' serious solvency issues, which they tried to resolve especially by raising their equity ratios.

The meanwhile legendary statement of the president of the ECB in July 2012 that he would do everything necessary within the central bank's mandate to keep the euro 'whatever it takes', has become the ECB's rallying motto – and, at the same time, its acid test. It took no more than the sheer announcement to make unlimited purchases of sovereign bonds with a maturity of three years to bring about a substantial drop in the yields of government bonds issued by Southern Europe countries. The ECB had achieved precisely what it set out to do when it launched its OMT programme: namely, to correct disturbances in the transmission process of money [Demary, Matthes, 2013, pp. 7 ff.]. In early 2015, the ECB took another important step towards a more relaxed monetary policy. In the frame of quantitative easing, by the end of 2016 it will purchase more than EUR 1 billion of sovereign and private bonds on the secondary market. This time, the aim is to raise the inflation rate to the target of 2%, bring about an expansion of base money, and lower real interest rates within the frame of boosting activity in the real economy.

The adoption of the European Stability Mechanism (ESM) by the German parliament in July 2012, the announcement of OMT by the European Central Bank, and its programme to purchase sovereign and private bonds in March 2015 have triggered heated debate concerning the admissibility of state guarantees in the frame of ESM and the ECB's mandate and given rise to hearings before the Constitutional Court.

3. The lender of last resort

Let's not forget: the point of departure was the circumstance that as a result of the euro crisis the ECB felt obliged to resort to unconventional monetary measures. The ECB perceived itself faced with a vicious circle of bank, macroeconomic and sovereign-debt crisis [SVR, 2012/2013, par. 107] which manifested itself in a major credibility crisis that threatened the very survival of the currency union. The ECB subsequently introduced the OMT programme in an attempt to promote implementation of the monetary decisions it had taken and jump-start their impacts on the real economy. In so doing, the ECB assumed the function of a lender of last resort on the part of the eurozone countries. Arising from this is the controversial question whether the act of assuming the function of a lender of last resort, instead of seeking to finance state budgets via taxes and loans, amounts to an impermissible way of financing sovereign debt. The configuration of OMTs provides for waiving seniority status in the order of priority for creditors: this means that the ECB itself takes on the entire risk of default when purchasing government bonds. It is suspected that the transfer of creditor risk to the ECB may equate to the ECB insuring against risk of default, and subsequently a transcending of the demarcation line between monetary and fiscal policy. If that were the case, the danger is that the ECB might fall under fiscal dominance [SVR, 2013/2014, par. 30][1]. And ultimately: once the demarcation line between monetary and fiscal policy has actually been transcended, who is then the fiscal actor responsible for income and employment policy within the macroeconomic division of responsibilities? Will this result in the ECB being not only the lender of last resort, but rather – taken to the logical though albeit exaggerated conclusion – also the employer of last resort?

Who were to be the clients of a lender of last resort – only banks, or whole states? Only so much is clear: Bagehot's famous rule that credit should only be granted against sound collateral in an amount 'as largely as the public ask for them' [Bagehot, 1874, p. 103] is directed on the one hand against the moral hazard represented by the investment banks, but also those states that all too casually call for third-party liquidity and thereby cause loss of trust in the reliability of their own liquidity commitments. At the same time it is a vote against a state lender of last resort granting credits to banks. It is the fundamental conviction of the Bank of England that it is answerable to no one and completely free from political coercion [Bagehot, 1874, chap. 8]. Less clear is how it should refinance itself. There can be no shortage of first-class collateral of the type foreseen by Bagehot: after all, there would only be a small number of individual credit institutions in need of protection against illiquidity in times of panic and potential bank runs, there could be no question of their difficulties being self-caused, and we would not be faced with the need to support the entire financial sector of a whole national economy. Such an event never entered his mind.

Central banks have no need of own equity – simply because they cannot become bankrupt. They are not left holding obligations when their debtors are unable to meet their commitments. Their loss is limited solely to their reputation for price stability. In current times of historically low price increase rates, the European Central Bank is far removed from losing its reputation in this respect. Notwithstanding, the question concerning what to do in the event of real central bank losses remains unanswered. On the one hand, there are seignorage effects in the form of balance sheet losses. These occur as result of lost profits subsequent to missing income from interest yielding money-creation activities. In such an event, the state suffers the loss of central bank income that would otherwise have accrued to it. Whether it becomes necessary for the state to recapitalize its central bank depends on how market players react and to what extent they honour trust in the functionality of a central bank. In any event, though, the monetary decisions taken by a central bank in its role as lender of last resort will always imply fiscal effects for the state via its tax regime.

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[1] The term 'fiscal dominance' was used by the President of the Bundesbank to exert pressure on the Central Bank to shape its monetary policy in such a way as to secure the solvency of states. An important driver of fiscal dominance is devaluation of debt induced by inflation [Weidmann, 2013a].

The financial crisis shockingly revealed that a central bank is also the lender of last resort towards sovereign states. However, Article 123 and Article 125 of the Agreement on the Functioning of the European Union explicitly prohibit the ECB from engaging in state bail-outs and state financing. From that angle, the matter would appear to be closed. Less clear, however, is the function of a lender of last resort *vis-à-vis* banks, for which so far no explicit rule has been agreed upon. The moral risk is expressed solely in respect of states. It is this asymmetry of rules concerning banks and states that gave rise to calls for a European bank union.

The legitimacy of a political institution is directly linked with the responsibilities it has to perform. The responsibility of a central bank is to create and maintain trust in a monetary economy, which means trust in the intrinsic value of liquidity. The banknotes issued by a central bank only represent value because their holders have trust in their real equivalent.

When trust in money becomes the sole control variable for the functioning of a modern economy, it follows that the outbreak of financial crisis in the real economy can be interpreted as a fundamental break in the established trust relationship between the spheres of the monetary and the real economy.

Only trust in its capability for unrestricted intervention makes a central bank credible. This is the sole function of a lender of last resort, an idea born over two centuries ago. In his famous speech held in London in 2012, Draghi simply reminded us of this. Creating trust and enforcing liability in times of crisis: these are the crucial principles of economic policy. Credibility, therefore, cannot be reduced to merely enforcing liability; rather, it can only be achieved by also creating trust. Only in combination do they make sense.

When the crisis broke out it would have made little sense if the ECB had merely stuck to its guns and insisted on the sole principle of enforcing credibility by observing the regulation concerning no bail-out and subsequently rejecting any joint liability, even of a conditional nature. On the contrary: it was precisely the act of breaching the no bail-out principle that opened the door to resolving the crisis. Credibility building via breaching the rules in order to return to the rules once the crisis is over: this is the essence of the political agenda of a currency union in the midst of its greatest challenge.

Of course, this leaves a number of issues unanswered. Let's deal with the most important one first: how often can an act like this be repeated? The clear answer is: not a second time – at least not with any certainty of success. If market players anticipate they might not be held liable for the costs of their actions, this would herald in the end of legitimacy for the communitisation of liability. It's not possible to repeatedly appeal to people's trust and at the same time take the question of liability too lightly.

The second important question concerns the legitimacy of decisions that, although they may on the one hand have created trust, were made against the rulebook. This much is clear: price stability and the financial stability it is linked to are public goods. They are not in rivalry with the consumption of other goods and nobody should be refused access to them, not even free riders. This may have formed the background for legitimising the ECB to break the rules.

The third question affects the actors who argue legitimation for the primacy of fiscal stability. For this much is also clear: the ECB now finds itself in a situation in which it has assumed responsibility for functions that essentially fall under the competences of fiscal or economic policies. Criticism of the way the European Central Bank interpreted its mandate in respect of ESM and OMT hence also constitutes criticism of other actors' failure to assume due diligence for financial stability in Europe.

Conclusions: On track to be the permanent lender of last resort?

Discourses surrounding monetary policy are still dominated by fundamental debate. Programmes like OMT, quantitative easing, and the granting of emergency liquidity aid against solvent though temporarily illiquid banks raise a number of serious issues concerning the monetary financing of state budgets. The thread running through these discourses was the search for pragmatic lines of crisis management in order to gain time for reforms without relieving the pressure for reform [SVR SG, 2015, p. 25].

The conflict situation between the ECB as the champion of monetary relaxation and the German Bundesbank as the doubting Thomas constantly reminding us of the danger of pent-up inflation remains unchanged since the outbreak of crisis in 2008. Clearly, the macroeconomic debate on the relationship between the monetary and the real spheres of the economy continues to be dominated by very different fundamental convictions.

Here, some historical comparisons may come in useful. In a major study on the history of monetary policy in the United States, Milton Friedman and Anna Schwartz [1961, pp. 299 ff.] impressively illustrate that the Great Depression of the 1930s would not have been nearly so dramatic if the Fed had actively exercised its role as a lender of last resort. For fear of triggering inflation, it actually reduced its monetary basis at a time when it should have been supplying the public with liquidity. Suicide for fear of death, you might say. However, to refuse to exercise the function of a lender of last resort for fear of inflation in times of the massive destruction of asset values experienced during financial and economic crisis appears rather absurd.

There are lessons to be drawn from the financial crisis. The most important is this: there is only a narrow dividing line between a liquidity crunch and a solvency crisis, and it may often be difficult to draw any distinct line between the two [Goodhart, 2002, p. 229]. This suggests there should be cooperation between monetary and fiscal policies. Financial stability and price stability are inseparable. A fiscal state should be aware that solvency problems harbour the danger of contagion and can lead to high costs for the real economy. To question the legitimacy of a central bank to exercise its brief as a lender of last resort and thus to promote dominance of fiscal considerations boils down to a dispute about principles, and hence places organizational principles above building trust in a monetarised world. A policy of lender of last resort is a very contradiction of terms *vis-à-vis* individual liability for liquidity crises. And in future, in such a divergent constellation as a currency union it is more than likely to happen again. The EWWU is far removed from being an optimal currency area, and it has to take account of this via its organizational arrangement of responsibilities. The European Central Bank will only be able to fulfil its mandate to safeguard price stability in a European currency area if it is allowed to act free from fiscal considerations.

Another lesson calls for fiscal backing in the shape of sovereign budgetary rights. A currency union can only be sustainable in the long term in coexistence with a political union. To achieve this necessitates transferring sovereign rights to the European level. This entails also establishing an insolvency mechanism for the states within a currency union that provides for dealing with national debts. A practical proposal could lie in a debt sharing covenant whereby national debt that exceeds the reference ratio of 60% of GDP is transferred into a mutual redemption fund with joint liability[2]. Distribution of the welfare effects of the currency area would then call for a fiscal compensation system similar to that of a federal state. The German Länder's fiscal equalization scheme might constitute a role model for the institutional arrangement of a European fiscal equalisation scheme. Hence, the political lesson to be learned from lender of last resort must not be that the central bank becomes the lender of last employment, but rather that it should be supplemented with a joint competence for finances and employment. There's still a long way to go, not only for the European Central Bank, but also in respect of the European Ministry for Economy and Finance, if the project of a European currency union is to be successful in the long term.

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[2] An accordant proposal was first made by the German Council of Economic Experts in 2011 [SVR, 2011/2012].

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