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Eurozone Bank Recapitalisations: Pouring water into a leaky bucket

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The sovereign debt crisis has degenerated into a banking crisis. This was perfectly predictable. A sovereign debt crisis always leads to a banking crisis. Yet policy-makers did not see it coming, or if they did see it, they failed to act in time.

We now hear that the solution is a massive and quick recapitalisation of banks. But who can recapitalise the eurozone banks quickly? In the present bearish conditions in the equity markets, only governments can quickly garner the financial resources necessary for this recapitalisation. But in order to do so, governments will have to issue more debt. The result of this is predictable: the creditworthiness of governments will deteriorate. Inevitably, this will intensify the sovereign debt crisis, feeding back into the balance sheets of the banks that hold the bonds of those who are supposed to save them.

Recapitalising banks made sense during the banking crisis of 2008 when governments had debt burdens significantly lower than today. Today governments cannot recapitalise banks without triggering downgrades and renewed fears of sovereign default. This leads to a vicious circle: recapitalisations undermine the creditworthiness of governments, and this feeds back into the banks, which see the value of their assets (government bonds) decline further. The more governments recapitalise the more the value of the banks' assets declines leading to the need for further recapitalisations. A never-ending story.

In order to stop this downward spiral, a floor has to be put on the prices of government bonds in the eurozone. The European Central Bank (ECB) is the only institution capable of imposing such a floor and breaking the vicious circle.

In order to achieve such a result, the ECB should announce that it stands ready to intervene in the government bond markets to prevent further declines in bond prices. The ECB is the only institution capable of doing so, because it has unlimited firing power. That is, it can create money without limit. In announcing its unconditional commitment, it can stop the vicious circle. And when investors are convinced of the resolve of the ECB, they will stop selling sovereign bonds because they trust that a floor has been imposed on their prices. The beauty of this outcome produced by confidence is that the ECB will not have to buy government bonds anymore.

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Today the ECB does not reap this benefit because it has made it clear that it thoroughly dislikes being a lender of last resort and that it will stop as soon as possible. Why would bondholders, who are uncertain about the future value of their bonds, stop selling these when the ECB gives a signal that it does not trust these bonds either?

In theory the central bank should only buy the bonds of illiquid but solvent governments. It is easy to see that this rule excludes Greece, but it does not exclude the other countries' bond markets. In these markets, fear has driven the interest rates to such high levels that, if maintained, they will make any government insolvent. It is in these markets that the ECB must intervene with a clear commitment.

Many objections are raised against the idea that the ECB should act as a lender of last resort in the government bond markets. One objection is that this amounts to monetary financing of budget deficits and thus will lead to inflation. This is unfounded. When the ECB buys government bonds in the secondary markets, it provides liquidity, not to governments, but to the financial institutions that sold the sovereign bonds. In addition, when these financial institutions sell the government bonds, they are in search of a safe asset, and this is primarily central bank money. The latter is hoarded and is not used to expand credit and the money supply, and thus does not lead to inflationary pressures.

The only reasonable objection to a lender-of-last-resort role for the ECB is moral hazard. By announcing its readiness to provide liquidity in the government bond markets, the ECB creates the risk that governments may reduce their efforts at reducing deficits and debts. That is why binding rules forcing governments to bring their budgetary houses in order must complement the ECB's role of lender of last resort. These rules are now being put in place.

The European Financial Stability Facility (EFSF) (and in the future, the ESM), is no substitute for the ECB. There are two reasons for this. First, the EFSF (ESM) will not be capable of acting quickly during crisis situations because its governance is based on the unanimity rule. This will paralyse it when quick action is required. Second, even a doubling or quadrupling of its resources will not help. The reason is that when resources are finite, investors and speculators will quickly find out that there are states of nature that will deplete these resources. As a result, the credibility of the EFSF (ESM) will be weak. This weakness can in principle be solved by transforming the EFSF into a bank with unlimited access to the ECB liquidity. But this solution puts the ECB again at centre stage.

The ECB has no excuse anymore not to act. Whether it acts directly or indirectly through the EFSF (ESM) does not make much difference. The ECB is the only institution that can avoid a banking crisis, and this can only be achieved today by acting in the government bond markets of the eurozone countries.

Finally, the fact that bank recapitalisations will not solve the present banking crisis in the eurozone does not mean that in the long run banks will not have to increase their capital ratios. Such increases will be necessary to make banks more resilient to avoid future crises. Today, however, the overriding problem is to put a floor on the price of government bonds; otherwise, recapitalisations will be as effective as pouring water into a leaky bucket.