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ECONOMIC VIEWPOINT

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Why the ECB Has to Be More Like the Federal Reserve

Europe's management of its crisis has been a classic case of too little too late. The core issue is that the European Central Bank (ECB) needs to act more boldly and broaden its concept of lender of last resort. In fact, it needs to act more like the Federal Reserve. This would be a dramatic departure for a central bank whose sole stated objective has been price stability; however, it is a necessary corollary to the need for greater fiscal management among Eurozone members. The ECB, as did the Fed, needs to restore confidence in the financial system and EU members need to demonstrate their financial resolve by fully funding their regional bailout system or by relying more explicitly on the International Monetary Fund to manage financing of adjustment programs.

Commentators have noted that the ECB needs to restore confidence to the financial system. So far it has acted only when forced by the major EU powers to either buy sovereign debt to preserve the fiction that risk is equal through the Eurozone or to extend financing—often ahead of the IMF or without appropriate policy conditions. To be fair, the ECB has been used as a tool for policymakers who themselves have been reluctant to take bold and necessary action, particularly with respect to Greek debt. That lethargy has fueled contagion, downgrades of debt and widening of spreads, and new concerns about the health of European banks.

The difficult issues are how to strengthen the banks without simply taking on sovereign debt at face value and, also, how to distinguish between Eurozone members that face liquidity challenges and those that require more fundamental debt restructuring. Here is where the past policies of denial vis-à-vis haircuts on Greek debt have done the most damage.

Much attention has been devoted to the mechanisms for taking on more sovereign debt by the ECB; however, this may not be the right answer. The solution may be to infuse capital into the banks but to discontinue exchanging impaired or potentially impaired government debt at par. Straight capital infusions would have the desired effect on bank balance sheets and on confidence. Similar to the United States' Troubled Asset Relief Program (TARP), the funds would likely be repaid with interest in a relatively short period. Clearly, the ECB would need to work closely with supervisory authorities to only infuse capital into sound banks.

That still leaves the issue of the necessary debt restructuring for countries such as Greece and, perhaps, others that cannot hope to grow out of their fiscal-financial crises without debt relief. Before more sovereign debt is moved from private to public balance sheets, these existing debt instruments need to be restructured, which can be done in most—but not all—cases without loss of principle. The moral hazard concern can be dealt with by allowing sovereign bond markets to reach their own equilibria; spreads will converge only when credible fiscal rules are enforced and not before. This can be combined with ECB actions that focus on non-sovereign asset exchanges to bolster bank capital.

The elements of the new policy regime could include:

- a new and expanded role for the ECB, taking cues from the Federal Reserve;
- new binding fiscal measures that have eluded the EU for some time, combined with a mandate obliging countries to turn automatically to the IMF when exceeding fiscal norms;
- recognition that debt restructuring of excessively indebted members can strengthen rather than weaken confidence in the euro;
- creation of an independent crisis management committee empowered to use the European Financial Stability Facility and engage with the ECB and the IMF without political interference.

Anything less will, unfortunately, fail to solve Europe's crisis of confidence this time or in the future. ■