Set ECB free – [Liberate the ECB]
Hostage taking by EU leaders should end

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The frictions in Euroland are reaching new heights by the day. Europe does not just face a north south divide – the creditors in the north balking at support for the south – but also a deepening divide within the ECB. Despite ECB president Trichet's mention of an overwhelming majority, the central bank presidents of key creditor states – read Germany and The Netherlands – were against the ECB buying up of government bonds of weak Euro member states. But they lost – the ECB has now expanded its government bond buying program.

The real divide however is between the Eurozone politicians and the ECB. There is a fundamental problem in the allocation of responsibilities within the eurozone. The ECB is pressured to bear responsibilities for sovereign risk of member states that it should not. It is now time to get the responsibilities right. If we do not, the credibility and political independence of the ECB will suffer a fatal blow.

Key to a sensible allocation of responsibilities is that sovereign debt problems and imbalances between Eurozone member states need to be addressed by elected officials on behalf of the tax payers that they represent. Budgetary problems and frictions in the economic management across member states are after all the prerogative of politicians.

However, politicians are footloose. The electorate in the various creditor states is not willing to give their politicians a mandate for providing sufficient support to weak states. Indeed, the leaders of Germany and the Netherlands have stopped the enlargement of the EFSF emergency fund (the European financial stability facility). Instead, the ECB is now being used by the Eurozone politicians to effectively provide support via the backdoor, i.e. the ECB buying up government debt on its own.

The latest episode is that the ECB is willing to support Italy if Italy institutes a credible restructuring of its public finances. But this is nothing more than a desperate jump in the unknown. The ECB has no instruments to enforce its demands on Italy. And once it owns a substantial amount of Italian government debt it is captured not just by the Italians but also by the Eurozone politicians that may or may not choose to support Italy.

It is at first sight curious why the Eurozone governments not fully and explicitly underwrite the sovereign risk that the ECB faces. The risks of the ECB failing are with the governments (and tax payers) anyhow, so why not let the ECB of the hook? From the point of view of a sensible allocation of responsibilities, it would make perfectly sense to put sovereign risk with the Eurozone leaders. After all those Eurozone leaders have the responsibility to make the right decisions on behalf of the Eurozone tax payers. That responsibility (and associated) decision making) gets defused if the ECB – with its own solvency concerns – is put in between. For example, regardless of how the ECB really looks at the desirability of debt restructuring of heavily indebted states, the ECB has to be adamant opposed to any debt restructuring if it could lead to its own default.

The ECB should be independent from the political process and deal with monetary policy and act as lender of last resort for Eurozone banking institutions objectively. But the ECB faces unique challenges as central bank of a common currency zone without common fiscal policy even if it would abstain from buying up government bonds. In particular, even as lender of last resort to Greek banks, for example, it may end up with Greek government bonds as collateral. Appropriate haircuts and diversification of collateral (limits on sovereign collateral) but also the transfer of these risks to euro member states are needed to contain the sovereign risk that the ECB would otherwise face.

We need to stop politicians from holding the ECB hostage. Eurozone leaders should deal with their ideal of holding the eurozone together, if that is still the objective. And that requires credible economic coordination across countries, and indeed a willingness to assume risk of other euro member states. For the short term, a massive emergency fund is needed with explicit mechanism to control member state risk. Such fund will help contain the turmoil in financial markets. But this is only an intermediate step: what type of future arrangements do we want to have in the eurozone? Eurobonds – effectively creating joint several liability that requires more or less a fiscal union with far reaching political integration? Or can a loser arrangement work with appropriate (extensive) controls and very timely intervention possibilities?

What is really at stake is that the Eurozone politicians can no longer escape their responsibility. Delegating the task of enforcing prudent economic policies of member states to the ECB is a last ditch attempt that is likely to fail. It is also a perfectly revealing signal of massive failure of euroland leadership. And letting the ECB be burdened with sovereign risk that it cannot – and is not supposed – to bear is truly a coward act. Financial markets have responded in kind.