

Why would the ECB sustain British banks' LiFE?

One little detail in the recent Brexit turmoil has been overlooked: Invoking an agreement between six central banks from 2013, the Bank of England in March activated its bilateral liquidity swap line with the European Central Bank. This technicality means, that British banks from now onwards will be able to obtain Euros directly from the Old Lady of Threadneedle Street. Tellingly, the Bank of England calls this new measure “LiFE”: Liquidity Facility in Euros.

This is odd in three ways: First, while Theresa May tries to sever the ties with the mainland, the unelected officials at the Bank of England strengthen them. Second, while British central bankers do not explicitly say so, the timing lets me (and others) assume this measure is intended to mitigate money market stress in case of a no-deal or bad-deal Brexit. That the ECB is willing to lend out Euros to British banks by way of the BoE doesn't directly seem to be motivated by price-stability concerns. Put differently: Why would the ECB help out the BoE and is this help within the ECB's mandate? Third, this measure points towards an inherent tension: While for example British importers will face higher costs due to the current uncertainty, the island's banks enjoy certainty with respect to their euro-funding costs. While this may be justified by the central role of the banking system within an economy, this instance highlights the explicit preferential treatment of banks which apparently don't have “to get fit for Brexit” because they have a backstop.

Why are standing swap facilities different?

For context, in the financial crisis the US Federal Reserve established so-called liquidity swap lines with a whole range of central banks around the world. In swapping their currency for dollars with the Fed, those other central banks could lend out dollars in their jurisdictions. The measure was intended to alleviate money market stress. All of these lines were subsequently ended again. Arguably, this lending of last resort backstopped the Eurodollar market. Historically speaking such international lending of last resort is quite common: Central banks have emergency-lent to each other gold or silver for numerous times in the 19th century. And the Fed and the US Treasury lending out dollars to Mexico in the mid 1990s is a recent such example.

What made 2013 different was that six central banks declared standing facilities of bilateral swap agreements to be present until further notice. With not immediate crisis, lending facilities would simply be there to use. Participating central banks are the Fed, the European Central Bank, Bank of Japan, Bank of England, Swiss National Bank and Bank of Canada. Especially the dollar line with the Fed is of interest because it has been active all the time. Dollar auctions are for example held at the ECB weekly and banks have made use of this every week since.

There is an increasing body of literature on Lender of Last Resort facilities in the Great Financial Crisis. What the March 5th announcement of the Bank of England highlights is that these facilities are far from being a “last resort”. They are not just ad-hoc put in place to deal with a crisis but rather there to alleviate stress before the crisis emerges.

Its international discount window lending!

Ricardo Reis and Salem Bahaj argue, that the facility essentially creates discount window lending in a foreign currency and thus puts a ceiling on deviations of Covered Interest Parity (the basis). From a central banker's perspective the feature is quite nice. With the Bank of England's concern for financial stability it is easy to see why being able to lend

Euros to its banks is handy when nobody is clear how future relations with Euro-governments will look like in the foreseeable future. It reduces contingency. And with Bahaj actually being employed at the Bank of England presently, they have in-house knowledge activating this feature puts a ceiling on funding cost deviations between the Pound and the Euro. This is beneficial for British banks in terms of competitiveness with European banks and lessens liquidity risks.

But what's the political economy here? Democracy, Legality, Interest-groups

These are aspects of economics. In terms of political economy, though, we have struggled so far to grasp this institutional innovation. This is why looking at the just recently activated swap line between the Bank of England and the ECB is interesting.

We have outlined above three oddities that arise from a political economy reading of the situation and will address them in turn. They are essentially structured by the themes of democracy, legality and interest-groups. It may also be important to note that we do not take umbrage with the facility (and even if we did nobody would care).

First, while it is government policy to get out of the European Union, the Bank of England strengthens integration with the European Central Bank. Prima facie, this only highlights features of global financialization: "the integration of previously national money markets and capital markets".

While "getting out of the EU" doesn't mean "getting the Euro out of Great Britain" we argue at least on an institutional level a link between central banks was permanently activated that wasn't there before. This mostly points towards the tension between democracy and central bank independence. With the latter being a tool of globalized finance, decisions that are "good" for the economy can be made without government policy interfering. The Independent puts it differently:

It means that even if the UK crashes out of the EU without a deal, the country will still remain reliant on Frankfurt to help safeguard the financial system.

Second, we are sure the European Central Bank did its legal checks when going forward with the standing facilities in 2013. But the ECB's mandate asks it to provide price stability for the Eurozone. Within this narrow reading there is no clear indication how backstopping the British banking sector is justified. On the other hand, stress in the British market would possibly spillover to the Eurozone. Then, the facility promotes financial stability in the ECB's jurisdiction. This institutional evolution towards financial stability is at least interesting with regards to current discussions on changing the ECB's mandate. There would be the argument that maintaining the active swap-line with the BoE comes at no cost for the ECB. It reduces the question why permanent liquidity swap lines emerged in 2013 to a "why wouldn't they?".

Third, we would like to point to the tension of interest groups. It is clear that distortions in money market funding would further ripple through the British economy and the active Euro-line may mitigate such risks. But living in London, we daily pass by advertisements from the government pushing businesses to get ready for Brexit. This clearly also applies to banks. They surely, too have to get a lot of work done in this regard. But they won't have to hoard Euros to remain liquid. On the other hand the UK's largest supplier of toilet paper stockpiles its main asset. Again, we're not disagreeing with the policy. But it clearly shows who is treated preferentially. Then again, we are sure the ECB would be happy to supply toilet paper and swap it for Pounds if it came for free to the ECB. And what's worse, no Euros or no toilet paper?