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August 2011: What to do when the euro crisis reaches the core

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Investors are anticipating the unravelling of the 21 July 2011 'solution'. We argue that the EFSF cannot work as intended; but if it were registered as a bank – which would give it access to potentially unlimited ECB re-financing in case of emergency – the generalised breakdown of confidence could be stopped while leaving the management of public debt under the supervision of the finance ministers. The ECB could still manage liquidity as the 'EFSF-bank' would be subject to the same rules as all other banks and because the ECB would accept only good quality collateral from it. Moreover, the ECB could then stop its purchases of peripheral government bonds immediately.

We also show that this would not be incompatible with the Treaty's prohibition of monetary financing.

Canaries used to be kept in coal mines because they die faster than humans when exposed to dangerous gases. When the birds stopped singing, miners knew that it was time to prepare for an emergency.

Greece, as it turns out, was the eurozone's canary. It was nevertheless resuscitated, and a small rescue mechanism was set up to revive a further canary or two – but beyond this the warning was ignored. The miners kept on working. They convinced themselves that this was the canaries' problem.

A Greek warning

The problems of Greece should have been recognised as the first manifestation of a general problem, namely that the global crisis was spreading to public debt as capital markets refused to refinance excessive levels of public debt, especially in the eurozone, whose members can no longer rely on central bank support.

This has become particularly evident since the July 2011 European Council – the meeting that was supposed to end the crisis by settling the Greek case with a mixture of generous long-term financing at low interest rates and some private sector rescheduling and restructuring.

The Greek public might not appreciate it, but it has received preferential treatment from the EU. With the decisions taken at the July European Council, Greece will essentially have all its of financing needs for the next decade arranged and is assured of paying less than 4% on the

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new debt it is incurring.[1] The two other countries with a programme, Ireland and Portugal, will have similarly low interest rates and loans with a longer maturity than now, but they are still expected to face the test of the markets in a few years' time.

The debt fears reach the core

But while Greece, Ireland and Portugal obtained lower rates for their official long-term financing, Spain and Italy experienced a surge in their borrowing costs. Before the intervention of the ECB they were paying more than 6% for ten-year money.

It is clear that these countries cannot be expected to provide billions of euros in credits to Greece (and Portugal and Ireland) at approximately 3.5% when they are themselves paying so much more. Even France has come under market pressure as doubts have arisen over the country's ability to deal with both its actual and contingent liabilities. Europe's leaders wanted to be generous towards Greece, but the supply of cheap funds is limited. Not everybody can be served this way.

The EFSF was designed for a peripheral crisis

In particular, the eurozone rescue fund, the European Financial Stability Fund (EFSF) simply does not, and will not, have enough funds to undertake the massive bond purchases that will be required to stabilise markets. It was sized to provide emergency financial support only to small peripheral countries such as Greece, Ireland and Portugal.

Moreover, the structure of the EFSF makes it vulnerable to a domino effect.

- The rules of the EFSF imply that a country that encounters financial difficulties and asks for support from the EFSF can 'step out', i.e. no longer provide guarantees for any further debt issuance by the EFSF (see Art. 2(7) of the EFSF Framework Agreement).[2]
- Even if it is not explicitly regulated, it can be expected that a country facing high borrowing costs (as in the case of Italy and Spain if rates stay at crisis level) will step out as guarantor and only the core eurozone members would remain to back the EFSF.

At this point, the debt burden on the core countries would become unbearable.

Dangers of applying the periphery solution to the core

This implies that a larger EFSF is not the solution; if anything it could accelerate the fall of the dominoes. The position of the French government – that the EFSF should be increased – does not make sense even from a narrow French point of view because financial markets have understood this risk and are driving up borrowing costs for France – the core country most in danger of losing its AAA rating. But if France loses its triple-A status and then has to 'step out' of the EFSF, only Germany (and some of its smaller neighbours) would be left to carry the whole burden. This would not only be politically unacceptable but also economically impossible – the Italian government debt alone is equivalent to the entire GDP of Germany.

How this drives the markets

In early August 2011, the domino effect started to kick in because financial markets do not wait for country after country to be downgraded; they tend to anticipate the endgame, or at least one potential scenario, namely the unravelling of the entire EFSF/ESM structure. Markets were caught between three, seemingly inconsistent constraints: 1) little chance of a

[1] See http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/123978.pdf

[2] See http://www.efsf.europa.eu/attachments/efsf_framework_agreement_en.pdf

sizeable increase in the borrowing capacity of the EFSF, 2) little chance of the introduction of Eurobonds and 3) a great reluctance on the part of the ECB to engage in large-scale purchases of financially troubled governments' bonds.

The bank-government-debt snare

As usual, banks are the weakest link. They create negative feedback loops and accelerate the transmission of the domino effect. There are two reasons for this:

- many banks hold large amounts of government debt and
- their credit ratings usually fall, along with that of their own sovereign.

This implies that anyone expecting a country's downgrade would not only be selling government securities but also its bank shares. This, in turn, increases the cost of capital for the banks, making them even weaker. Moreover, even stronger banks – which see their own share prices falling and credit-default spreads widening – react by refusing to provide the other banks with interbank liquidity. The breakdown in the interbank market, in turn, leads to a breakdown of the credit circuit, which kills growth.

This was the dynamic that led to the severe recession experienced after the Lehman bankruptcy.

It is now apparent that capital markets are anticipating the potential for a doomsday scenario, with the economy falling abruptly into recession as the interbank market breaks down and public debt problems are expected to grow. Unfortunately, these expectations will materialise unless the breakdown of the interbank market is addressed immediately.

What needs to be done?

To avoid the worst scenario, the eurozone needs a massive infusion of liquidity. Given that the existing cascade structure of the EFSF is part of the problem, the solution cannot be a massive increase in its size. Rather, the EFSF could simply be registered as a (special) credit institution with access to re-financing by the ECB in a case of emergency. The new EFSF, which we would prefer to call the European Monetary Fund (EMF), would then have access to ECB funding as do other banks, for which the central bank acts as a lender of last resort.

The EMF would have two departments.

The first department would manage and fund adjustment programmes and, if adjustment is impossible without debt reduction, facilitate orderly debt restructuring along the lines of the Brady Plan. Adjustment funding and help for debt restructuring would be backed fully by member states. [3]

The second department, which we would call the financial stability department, would counter liquidity logjams in euro area sovereign bond markets through intervention in secondary markets. Smaller secondary market intervention in the case of limited liquidity gaps could be funded with own resources of the EMF (like the operations in the first department). However, in the event of a big liquidity crunch, the EMF could access ECB facilities by borrowing against the government bonds it is purchasing as collateral. Assuming that the ECB insists on the top quality of the assets it takes for collateral—as for instance assured by a high rating—it would ensure that it only lends in the event of a liquidity crunch and not when a country suffers insolvency. The decision to intervene to buy national government bonds to protect financial stability would be taken by the EMF, based

[3] The limited market borrowing capacity of the EMF would ensure that debt is restructured when adjustment has failed.

on expert assessments and under the supervision of Finance Ministers, in conjunction with the ECB and the European Systemic Risk Board (as already foreseen in the Conclusions to the July 21 European Council). Hence, the ECB, whose task is not to determine fiscal policy in specific countries, would again be able to look after price and financial stability for the euro area as a whole.

Our proposal is institutionally far superior to the present arrangement, where the ECB uses its Securities Markets Programme (SMP) to pressure the Italian government into reforms and fiscal adjustment. There is no representation of the European taxpayers on the Governing Council of the ECB, which might have a tendency to be overly concerned about instability in financial markets and have too little regard for the interests of taxpayers.

The ECB would still be able to control liquidity developments for the entire euro area because once financial markets have returned to normal it could simply stop its policy of full allotment. At this point any refinancing by the EMF would simply crowd out financing to other banks and thus not increase area-wide liquidity.

Backstopping the EFSF via the ECB – i.e. creating an EMF – would have the advantage over the current mess in that it leaves the management of public debt problems in the hands of the finance ministries, and provides them with the liquidity backstop that is needed when there is a widespread breakdown of confidence. In a crisis of confidence the fundamental problem of banks and governments is always one of liquidity. This is exactly when a lender of last resort is most needed.

The ECB is the only institution that can provide the required 'lending of last resort' quickly and in convincing quantities. It would of course be much better if the ECB did not have to 'bail out' the European rescue mechanism, but in this case one has to choose between two evils. As long as it is temporary, even a massive increase in the ECB's balance sheet constitutes a lesser evil than a breakdown of the eurozone financial system.

But would our proposal be consistent with the European treaties? We think so. Article 123, §1 of the TFEU forbids direct ECB credit to public institutons so as to avoid monetary financing of fiscal deficits. However, Article 123, §2 exempts banks owned by the public sector from this prohibition. Thus, public banks such as the European Investment Bank or the German KfW (which extends the German part of funds for the adjustment programme to Greece) have access to ECB windows. Moreover, Council Regulation No. 3603/93 from 13 December 1993 exempts the IMF and the balance-of-payments-assistance-facility (renamed the European Financial Stabilisation Mechanism – EFSM) from the prohibition of receiving ECB funds. Hence, we do not see any serious legal obstacle to giving emergency access to ECB funds to the department of the EMF charged with the prevention of financial crises through intervention in secondary sovereign bond markets (see the Annex for further discussion of this issue). On the contrary, we believe that our proposal would help end a situation in which the ECB contravenes the spirit of Article 123, and would avoid other alternatives being discussed currently that would be politically and legally even more dangerous.

The dangers of introducing political union without democratic legitimacy

Another solution touted by some has been to establish joint and several liability for euro area countries' debt by introducing Eurobonds. The danger here is that holding taxpayers fully and unconditionally liable for spending decisions taken in other countries would most likely turn into a poison pill for EMU. Political resistance against EMU would grow in the stronger countries, eventually leading to a probable break-up of EMU. Moreover, if the issuance of Eurobonds were limited to a part of national debt (say only 40-60% of GDP, as proposed), highly indebted countries would immediately be forced into a debt restructuring as they

could no longer find buyers for the part only guaranteed nationally.[4] Moreover, this approach would require a change in the EU treaties and would probably not be compatible with the German Constitution.

Another variant of Eurobonds would be for all euro area countries to provide a 'joint and several' guarantee for the EFSF. This would still have most of the political disadvantages mentioned above, but at least it would not create the additional problems of the blue/red bond proposal.

Whatever the variant, Eurobonds can only make sense in a political union and even then only when debt levels are low.[5] When starting debt levels are so high that the markets suspect a debt overhang, Eurobonds would amount to a large transfer of risk and of course strong expectations that future accumulations of debt will be treated in the same way.

No silver bullet

Bringing EMU back to safe ground will of course only succeed if debt and deficits are reduced substantially. The financial crisis has clearly demonstrated that excessive debt loads and new deficits cannot be financed in anything but extremely benign markets. Countries that accumulate excessive debt will inevitably experience their 'Minsky moment',[6] when the rolling over of this debt becomes impossible. For a stable EMU, a long-term programme of debt reduction is a *conditio sine qua non*. However, debt reduction takes time, hence the need for an effective crisis management mechanism along the lines sketched out above. One without the other will not work, and EMU will fail.

Our proposal will certainly dissatify the purists who regard EMU as the re-birth of the gold standard. For the purists, our proposal amounts to a thinly veiled monetary financing of government debt. We would respond by saying that in the real world of today a pure gold standard-like arrangement will not work. In today's environment, the central bank needs to look after financial stability, which means that it needs to assume the role of a lender of last resort to banks and—because of the bank-government-debt nexus described above—also governments. The question is not whether, but how this role is performed.

[4] It could be different if in cases of default part of the bonds – say a sum consistent with a 60% debt ratio – were guaranteed by the community of euro area states (through a provision in the bond covenant). In this case, the guarantee would only kick in in case of default, while market participants would have a better idea of the recovery value.

[5] The federal government of the newly created US in the late 18th century assumed the debt of the founding states because that debt had been incurred fighting for a common cause. This is certainly not the case in Europe today.

[6] Named after economist Hyman Minsky and coined to describe the 1998 Russian financial crisis, the Minsky moment comes after a long period of prosperity and increasing values of investments, which has encouraged increasing amounts of speculation using borrowed money.

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Annex: Legal Issues

It might be argued that our proposal is not compatible with the prohibition of monetary financing of public bodies. However, this is not the case. The financial stability department of the EMF would essentially perform the same function as many private sector investment funds located (in Luxembourg and elsewhere), which are recognised as MFIs by the ECB and thus have access to normal eurosystem refinancing. These funds usually specialise in investing in euro area government bonds. The EMF could thus just create a special 'sub'-vehicle ('distressed debt') whose purpose would be only to buy bonds on the secondary market. This vehicle could thus be operated just like any investment fund that invests in 'distressed' debt (i.e. buy when yields are high). This sub-vehicle would not extend credit to governments, it would only perform a function that is undertaken today by the eurosystem itself. There is thus no material reason why this activity should fall under the prohibition of the ECB to finance governments (Article 123 of the TFEU).

Article 123(1) states:

> Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as "national central banks") in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.

The key legal point in this article hinges on the status of the EFSF/EMF rather than on who ultimately benefits from the funding the ECB provides. The key issue would then be whether the EMF falls under any of the categories listed in Article 123, paragraph 1. Nowhere in Article 123(1) is there a reference to indirect funding, or the purpose for which access to ECB funding is to be made; there is simply a prohibition on certain classes of entity from receiving ECB monetary financing.[7]

One could of course argue that since the EFSF is fully owned by governments it falls under the category of 'public untertakings'. However, Article 123(1) did not prevent the European Investment Bank (an EU body, but with a distinct legal personality, registered in Luxembourg, like the EFSF and owned by member states and the Commission) from obtaining refinancing from the ECB. In 2009 the EIB was recognised as an "eligible counterparty" by the ECB with access to ECB refinancing "as any other counterparty". As the ECB itself explains in a press release of 7 May 2009, this was "a natural complement to the EIB's financing initiatives". The reason is that paragraph 2 of the same article provides an exemption:

Article 123(2) reads:

> 2. Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions.

This means that the EFSF (or perhaps only its financial stability arm) could benefit from the exception in Article 123 paragraph 2, if it could be considered a publicly-owned 'credit institution'. Given that, as mentioned above, a number of investment funds are recognised as credit institutions there is no substantial reason why this should not be possible.

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[7] Those arguing against our proposal are coming from the perspective of what the ECB funding to the EFSF will be used for, i.e. indirect government financing, but neither Article 123 nor Council Regulation (EC) 3603/93 mentions indirect financing – Article 123 only refers to direct financing.

We note that in Germany the bilateral loans to Greece have been channelled via the KfW (Kreditanstalt für Wiederaufbau), which is also fully owned by the government and not a bank in the narrow sense of the word. However, the KfW is an 'eligible counterparty' for the ECB as it is registered as an MFI. The KfW could thus refinance its lending to Greece (now over €10 billion) via the ECB, if it wanted to.

In 2013, when the ESM will replace the EFSF, it will become a public law institution. However, this should not be a real obstacle. The case of the European Investment Bank (EIB) provides an important analogy here, as the EIB is certainly a public body (and publicly-owned). In the ECJ's case law, the EIB is legally deemed to be an autonomous entity ,distinct from the EU but nonetheless a body intended to contribute to the attainment of the Union's objectives. As a result, it falls outside the category of entities listed in Article 123, paragraph 1.

Finally, the most direct way to ensure that access by the EFSF/EMF to the refinancing operations of the ECB does not encounter legal obstacles would be to simply make a small change in Article 7 of Council Regulation (EC) No 3603/93 of 13 December 1993,[8] which exempts both the financing of the IMF and the financial assistance to non-euro-area membership from the scope of Article 123. Given that financial assistance to euro area member states will soon also have a treaty base (via the addition to Article 136, which has already been agreed politically) it would be appropriate to deal with the assistance to euro area member states. A change in the Council Regulation could be agreed quickly by the heads of state.

[8] The financing by the European Central Bank or the national central banks of obligations falling upon the public sector vis-à-vis the International Monetary Fund or resulting from the implementation of the medium-term financial assistance facility set up by Regulation (EEC) No 1969/88 (4) shall not be regarded as a credit facility within the meaning of Article 104 of the Treaty.