



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

**POLICY DEPARTMENT**  
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**The ECB, the EFSF and the ESM -  
Roles, Relationships and Challenges**

**Monetary Dialogue  
December 2011**

**COMPILATION OF NOTES**







DIRECTORATE GENERAL FOR INTERNAL POLICIES  
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

# **The ECB, the EFSF and the ESM - Roles, Relationships and Challenges**

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**COMPILATION OF NOTES**

## **Abstract**

The ECB has been an active and vocal institution in the crisis response in the EU. With its non-standard monetary policy operations, it has upheld wide scale emergency support for the banking system. Whatever the final design of the amended EFSF and also ESM may look like, it will have an influence of the role of the ECB. In this compilation of four notes provided by members of the Monetary Expert Panel the roles, relationships and challenges between the ECB, the EFSF and ESM are examined in more detail.

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## INTRODUCTION

The ECB has been an active and vocal institution in the crisis response in the EU. With its operations, it has upheld wide scale emergency support for the banking system. The ECB was also active in the creation of the European Financial Stability Facility (EFSF), and of the planned European Stability Mechanism (ESM). The recent ratification of the amended EFSF in all 17 euro area Member States is regarded as a pivotal step in the resolution of the sovereign debt crisis. The Treaty Establishing the European Stability Mechanism has still to enter the national ratification processes.

The ultimate design of the amended EFSF is still open since on important "technical details", i.e. the EFSF Guidelines, has still to be decided. The highly controversial details include inter alia the granting of a bank licence to the EFSF, i.e. providing access to ECB funding and how the EFSF might increase its 'firing power' by using leveraging.

Whatever the final design of the amended EFSF and also ESM may look like, it will have an influence of the role of the ECB.

- What will be the relationship of the amended EFSF, the forthcoming ESM and the ECB?
- Are some 'non-standard policy' measures of the ECB becoming obsolete with the amended EFSF and, eventually, the forthcoming ESM?
- How will a possible leverage mechanism for the EFSF influence the rating of the guarantor countries?
- What, if anything, needs to be changed in existing legislation and statutes in order to ensure a smooth functioning of the new mechanism?
- How should appropriate accountability and transparency be organised as regards the amended EFSF and ESM?

Members from the Monetary Expert Panel elaborated on these questions in more detail.

## **ABSTRACTS**

### **Charles WYPLOSZ - 1. The ECB, the EFSF (and the ESM)**

The creation of the EFSF has allowed the crisis to fester and spread. It made sense under the belief that the crisis would be circumscribed to a small number of small countries. This belief was mistaken in the first place and has now been proven wrong. The EFSF now threatens to delay the unavoidable acceptance by the ECB that is the Eurozone's lender of last resort. For the crisis to be brought under control, all public debts will have to be partially but explicitly guaranteed. This can be done by the ECB directly or by the ECB via the EFSF, once it has been granted a banking license.

### **Stefan COLLIGNON- 2. The ECB, the ESM and Stability Bonds: A Way Out of the Crisis**

The Euro Area is on the brink of a melt down unless urgent action is taken. The paper looks at the constraints on the EFSF and for ECB interventions, which limit the capacity to bail out Member States. The issue of Eurobonds could solve some of these issues, although the Commission' Stability Bonds may take too long for their realisation. A transition proposal is made, that would give both the EFSF and the ECB a constructive role in overcoming the crisis

### **Daniel GROS and Thomas MAYER - 3. How To Back Up the Rescue Fund?**

More and more investors are anticipating the unravelling of the euro area because the 'leveraged' European Financial Stability Facility (EFSF) cannot work as intended. This note argues, however, that if the EFSF (and the European Stability Mechanism or ESM) was registered as a bank – which would give them access to potentially unlimited ECB re-financing in case of need – the generalised breakdown of confidence could be stopped while leaving the management of public debt under the supervision of the finance ministers. The current version of the ESM Treaty would already allow a refinancing of the ESM via the European Central Bank (ECB). There is no danger for price stability under this approach, as the ECB could still manage liquidity while the 'EFSF/ESM-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 be compatible with the Treaty's prohibition of monetary financing.

### **Ansgar BELKE - 4. Political-Economic Options and Constraints for the EU Summit - ECB, EFSF and Austerity Programmes**

This paper describes the political-economic options and constraints for the December 2011 EU Summit and discusses potential causes of a non-zero probability of a breakup of the euro area. We analyse both against the background of inconsistencies of current political strategies to save the euro such as rescue packages, the EFSF, ECB bond purchases, austerity programmes and combinations of them.





**DIRECTORATE GENERAL FOR INTERNAL POLICIES  
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

# **The ECB, the EFSF (and the ESM)**

**Charles WYPLOSZ**

## **NOTE**

### **Abstract**

The creation of the EFSF has allowed the crisis to fester and spread. It made sense under the belief that the crisis would be circumscribed to a small number of small countries. This belief was mistaken in the first place and has now been proven wrong. The EFSF now threatens to delay the unavoidable acceptance by the ECB that is the euro area's lender of last resort. For the crisis to be brought under control, all public debts will have to be partially but explicitly guaranteed. This can be done by the ECB directly or by the ECB via the EFSF, once it has been granted a banking license.

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## EXECUTIVE SUMMARY

Along with the bailout by governments, the May 2010 decision by the ECB to get involved has radically transformed the situation. Had it refused to contribute to the bailouts, the ECB would have accelerated the unavoidable sovereign defaults, but it would have extricated itself from subsequent pressure. In effect, the ECB has set itself as lender of last resort.

The creation of the EFSF was seen as a solution, alongside with IMF co-financing, at a time when policymakers mistakenly believed that the crisis could be circumscribed to a few small peripheral countries. This belief can no longer be sustained. The public debts at risk now total several trillions of euros and a banking crisis, now inevitable, will raise the needs for emergency financing.

Five observations will have to be accepted before the crisis is brought under control:

1. The EFSF has been inadequate answer to the crisis.
2. The EFSF itself has become a channel of contagion.
3. The EFSF only makes sense as a way to shield the ECB from getting too deeply involved, but this effort has now collapsed.
4. The ECB has used the EFSF as a pretext to reject a role of lender in last resort.
5. The idea to transform the EFSF into a bank with access to ECB lending may be a way to window-dress the long-needed complete involvement of the ECB that will bring to an end a crisis that threatens its very existence.

It follows that we do not need an ESM or any other form of European Monetary Fund. We need discipline to be firmly, credibly and durably established in the Eurozone. Unless this is done, the euro will disappear. Once this is done, there is no reason to have a rescue fund.

## 1. INTRODUCTION: DO PRESIDENTS MATTER?

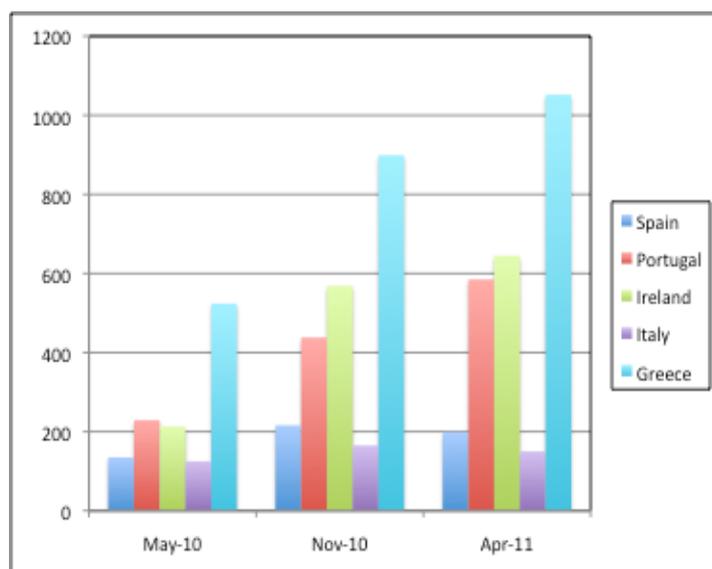
The sovereign debt crisis has created an unexpected situation, which has been met by unplanned policy actions. This includes the creation in May 2010 of the European Stability Financial Facility (EFSF), initially designed to last three years. When it became clear that the crisis would be bigger and would last longer, the EFSF mandate was enlarged and it was decided to make permanent by creating a successor institution, the European Stability Mechanism (ESM). In parallel, the ECB has constantly expanded its role, in effect complementing the EFSF. It is logical, therefore, to examine the relationship between the ECB and the EFSF.

This briefing note will argue five points. First, the EFSF has been inadequate answer to the crisis. Second, the EFSF itself has become a channel of contagion. Third, the EFSF only makes sense as a way to shield the ECB from getting too deeply involved, but this was an effort bound to fail. Fourth, the ECB has used the EFSF as a pretext to reject a role of lender in last resort. Fifth, that the idea to transform the EFSF into a bank with access to ECB lending may be a way to window-dress the long-needed complete involvement of the ECB that will bring to an end a crisis that threatens its very existence.

## 2. THE EFSF IS A FUNDAMENTALLY FLAWED RESPONSE

The first flaw reflects a misunderstanding of the likely evolution of the debt crisis. Clearly, in May 2010, the hope was to circumscribe the crisis to Greece but the simultaneous creation of the EFSF was an admission that more countries could follow. The first loan to Greece (EUR 110 billion) was not financed by the EFSF but through bilateral loans. This was a situation of emergency and we could not await the creation of the EFSF (statutes, ratification and fund raising). Why then do both? One possibility was a tacit admission that the first loan to Greece would be insufficient. Another possibility was an effort to ring-fence other countries (Ireland and Portugal) that were already facing worrisome borrowing costs, see Figure 1. This is an on-going problem.

**Figure 1 Ten-year bond spreads (basis points)**



Source: IMF

The EFSF was first used in November 2010 to bail out Ireland. By then Portugal was already losing market access. Indeed, in April 2011, Portugal applied for a bailout. Figure 1 also shows that these loans failed to reduce the spreads of the recipient countries while spreads started to build up in Italy and Spain: by the time of the Portuguese bailout, Italy and Spain had spreads of the some order of magnitude as those of Ireland and Portugal at the time of the Greek bailout. At the time of writing, this applies to Belgium and France, with Austria getting there.

Why are the bailouts failing? The answer is simple: ring fencing requires the mobilization of resources that are commensurate with the sovereign debts that can become the object of market concern. The next section deals with contagion and concludes that, potentially, all 17 countries can lose market access. This is a situation that policymakers chose to rule out in May 2010, even though it was quite plausible. Equally importantly, they focused on the financing needs of Greece and other countries over the following year or so. This reasoning – familiar in IMF programs as well – contravenes a basic principle of finance: all existing asset stocks can be off-loaded in a panic situation. Offering a country the resources needed to cover their immediate financing need does not prevent the markets to jettison all of the existing bonds if the feeling – justified or not – is that the government might default. The growing spreads since May 2010 show that this is exactly what happened: the markets started to download more and more Eurozone sovereign debts.

By failing to understand how financial markets function, policymakers did not just allow the crisis to fester. They were led to mistakenly believe that a “big” EFSF would impress the markets. They announced an amount of EUR 750 billion, in a move designed to “shock and awe” the markets. This move has failed. To start with, there never was EUR 750 billion. This amount included EUR 60 billion from the Commission; with an annual budget of about EUR 120 billion, the Commission always was unlikely to mobilize such an amount, and the idea has been quietly shelved since then. It also included EUR 250 billion from the IMF, but the IMF never precommits to making loans. The rest, EUR 440 billion was supposed to come from the EFSF; but requiring that the EFSF be given a AAA rating implied that only EUR 250 billion was actually available.

Anyway, even EUR 750 billion was not going to impress the markets for long. Table 1 displays the value of public debts, ranked in likely order of falling prey to market concerns. The last column cumulates these amounts. The debts of Greece, Ireland and Portugal were small enough to make EUR 750 billion commensurate, but adding Spain and Italy takes us to an altogether different order of magnitude. Once Spanish and Italian spreads rose in July 2011, the crisis entered a new phase. The EFSF, even leveraged to EUR 1000 billion – which is highly unlikely – is simply not up to the task.

### 3. THE EFSF AS SOURCE OF CONTAGION

There are three ways (at least) why the EFSF has worsened the situation. The first one is that it implies that one country's indebtedness problem is a collective problem. This is of course what the no-bailout clause (Art.123 and 125 TFEU) intended to rule out. The EFSF has been created to provide substitute collective funding to countries that loose market access, or equivalently face borrowing cost that are unsustainable. The message from the EFSF is: "a Eurozone country's financing needs are provided by the other countries". If these needs are large, then the whole euro area face unsustainable borrowing needs. For the markets, therefore, the next question immediately becomes: which is the next country that will tip over because of its guarantee to the EFSF?

**Table 1 Public debts in 2010 (EUR billion)**

	National debts	Cumulated
Greece	329	329
Ireland	148	477
Portugal	161	639
Spain	642	1281
Italy	1843	3123
Belgium	341	3464
France	1591	5055
Austria	206	5261
Netherlands	370	5631
Germany	2062	7693
Euro area		7844

**Source:** European Commission

The second channel of contagion is that the EFSF is a *de facto* Eurobond. The euro area collectively borrows to relend to a country that may default. This is probably why policymakers wanted to avoid sovereign defaults (in addition to the dubious view that "we are not Latin Americans"). This is however a commitment that can be credibly undertaken. Once a country looses market access, it is most unlikely that it recover access without a significant haircut. Borrowing from the EFSF merely increases the public debt that markets already considered as too big to be honoured.<sup>1</sup>

The EFSF therefore functions as follows. When Greece was bailed out, all other 16 countries borrowed in its stance. When Ireland was bailed out, all the remaining 15 countries borrowed. The remaining 14 countries borrowed to help out Portugal. As we move down Table 1, the number of countries that have to borrow dwindles, meaning that ever larger amounts of collective debt are being assumed by an ever smaller number of countries. Large Spanish and Italian debts are a direct threat on the ability to borrow of the largest contributors to the EFSF, France and Germany. Like dominos, the euro area countries are lined up and destined to "fall" one on top of the next one. This is not bad luck, it is an entirely predictable process.

<sup>1</sup> It seems that policymakers still believe that market access will be recovered without significant involuntary defaults. This belief remains one of the last bastions of the "wishful thinking" that has hampered proper treatment of the crisis from its start.

The July 2011 decision to allow the EFSF to intervene on secondary markets – in addition to lending directly to governments – is perfectly understandable. This is when policymakers started to understand that providing for financing needs is not enough and that the whole stock of debt is under threat. Asking the EFSF to undertake this task only strengthened the second channel of contagion.

The third channel of contagion involves the banks. Once markets conclude that a country will have to default, they naturally ask which investors will face haircuts. It turns out that banks hold large amounts of public debts, because sovereign bonds were traditionally seen as safe. The implication is that a country's default will shake banks, both at home and abroad. The result is a lethal vicious circle. For instance, the French government is borrowing to help out Greece, but some French banks own significant amounts of Greek bonds – and are apparently “asked” by their authorities not to sell them. To the markets this means that, when (not if) Greece defaults, France stands to suffer losses from its EFSF guarantee *and* to have to recapitalize some of its banks. Greece is small but with similar expectations holding for Italy, the markets conclude that France too will eventually lose market access. This is a self-fulfilling process; it matters little whether the calculations are right or not, eventually France is drawn into a crisis situation.

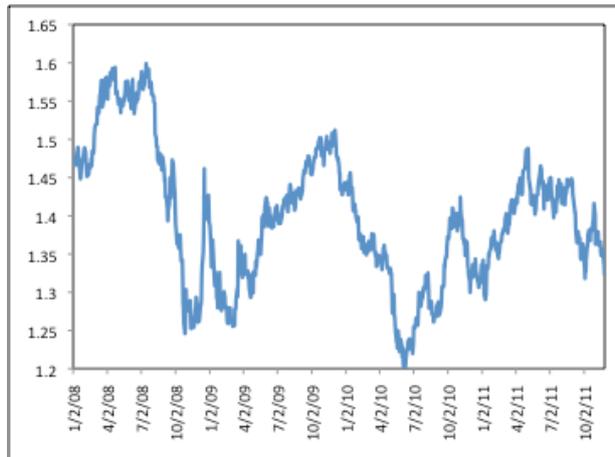
## 4. THE EFSF AS A EUROPEAN MONETARY FUND

The EFSF can be seen as a budding European Monetary Fund. Do we need for such a new institution? The question is not simple. We already have the IMF, an institution with considerable experience (and where Europeans hold considerable influence, both formally and informally). The early statement by ECB President Jean-Claude Trichet, that calling in the IMF is excluded, appeared to assert a rejection of external meddling in domestic affairs. This rejection is familiar: virtually every country that needs external help starts by denying the need and by refusing to lose temporarily a restriction to its sovereignty. It may be surprising that Europeans, who have championed the IMF for decades and exerted “friendly” pressure on countless countries to accept the inevitable, fell in the trap themselves.

The rejection is much deeper, however. It foretold the policymakers’ desire to europeanize the Greek debt crisis. It made it unavoidable that the bailout clause would be broken. It also set up an impossible situation for the ECB itself. Had the crisis be confined to Greece, it could have worked. Had the EUR 110 billion loan to Greece been enough to solve the problem, the ECB would have stayed out of the picture. This may have been the ECB’s calculation. If so, it reveals a profound misunderstanding of financial crises for the reasons developed in the two previous sections. In fact, the simultaneous creation of the EFSF betrays official concerns that there was a serious risk that the crisis would not be confined to Greece. Worse, the ECB’s own involvement in the bailout shows that its initial bet was already lost by May 2010.

The idea of a European Monetary Fund further draws an unjustified parallel with the IMF. The Fund’s lending operations are designed to provide countries with balance of payment difficulties with the international currency(ies) that they need to carry out trade and to honour their international financial obligations. In 1998, Japan suggested to set up an Asian Monetary Fund as a tool to pool regional foreign exchange reserves at a time when some East Asian countries were seeing their own reserves being depleted in defence of quickly collapsing exchange rates. This is absolutely not the situation faced by the euro area in early 2010. There was no shortage of dollars or other international means of payments. In fact, the euro is an international currency and its exchange rate has hardly changed since the onset of the crisis, as Figure 2 reminds us. As a whole, the euro area was not in crisis.

Greece, on the other hand, was in crisis. Its exchange rate was not under pressure because of its exchange rate. This is the deep sense in which euro area membership has played a little appreciated protective role for Greece and the other countries in crisis. A European Monetary Fund was useless in the sense that there was no shortage of non-euro international currencies. On the other hand, Greece needed euros to keep its public debt afloat. Not having a central bank of its own, it could obtain loans in euros from the IMF, from other countries, or from the ECB. The choice to create the EFSF was consistent with the view that “we do not need the IMF” and that we do not want the ECB to get involved. Why then create the EFSF, go to the IMF and involve the ECB? The next section examines one possible answer.

**Figure 2. The dollar value of the euro**

Source: ECB

## 5. THE ECB HIDES BEHIND THE EFSF

Of the three institutions, the EFSF, the IMF and the ECB, one has unlimited access to euros: the ECB. The May 2010 announcement that an amount of EUR 750 billion was available, EUR 250 billion of which from the IMF, has set an implicit arrangement that the Fund would provide one third of loans to euro area countries. This is indeed the rule that was followed for Ireland and Portugal and that is contemplated for the second Greek bailout. However Table 1 shows that contagion to Italy and Spain will require amounts several multiples the EUR 750 billion pre-announced amount. A banking crisis would require another time that amount.<sup>2</sup> The markets have long made that calculation and this is why the crisis is not coming to an end. They have concluded that the EFSF and the IMF will run out of euros before the bailouts are completed.

This is why pressure has been rising on the ECB to move forward and act as lender of resort, i.e. to make it known that its unlimited financing capacity will be mobilized. As is well known, the ECB refuses to take that step. Instead, whenever spreads move to a new higher step, the ECB buys sizeable amounts of stressed sovereign bonds but publicly states that these are once off operations, which should not be seen as an indication that more will follow. Instead, the ECB routinely invites governments to do more, which means more secondary interventions by the EFSF.

Indeed, the EFSF has been actively supporting the creation of the ESM and it has championed the July 2011 decision to allow secondary market purchases by the Facility. It is clear that the ECB hopes that the EFSF will succeed as lender of first resort, alongside the IMF, without have to act itself as lender of last resort.

<sup>2</sup> Realistic estimates of the needs of banks are now provided by academic researchers on the regularly updated website <http://vlab.stern.nyu.edu/welcome/risk/>.

## 6. THE EFSF AS A BANK

The arguments and evidence presented so far lead to the conclusion that the crisis can only be brought to an end by the ECB. The EFSF is a sideshow that provides the ECB with an excuse not to act as lender of last resort. The question, therefore, is whether the ECB will move before the situation reaches catastrophic proportions. What is needed is a way to reassure the ECB, which seems to worry mainly about two things.

Obviously, any central bank is rightly concerned with the moral hazard created when it monetizes the public debt. The solution to that problem is to clearly separate out the past, i.e. the backlog of excessive debts, with the future, i.e. the absolute need to achieve fiscal discipline. The ECB holds the key to ending the crisis; it needs firm reassurance that fiscal discipline will be firmly established. Government promises are not credible, given past behaviour. The solution will have to rest on new institutions. Institution building, however, takes time, much more time than is available to stop the crisis.

The ECB also seems to be concerned about losses that it could suffer as the result of its interventions. This is understandable, yet not a compelling argument. A central bank is part of the public sector so it matters little for the taxpayer where possible losses appear. A complicated factor within the euro area is the risk of transfers from undisciplined to disciplined countries. One thing should be clear, however: a central bank can have negative capital. A central bank is not a normal institution or a corporation; it can never run out of cash. In fact, some of the world's best central banks have been operating for years with negative capital: this is the case of the Central Bank of Chile and of the Bank of Israel.

In the end, therefore, the ECB needs some assurances and some distance from its inevitable role as lender of last resort. This is why the proposal by Gros and Mayer that the EFSF be granted bank status is interesting. The idea is that as a bank the EFSF could borrow from the ECB and therefore underwrites the Eurozone's sovereign bond. The losses would be those of the EFSF, not of the ECB. The ECB could even claim that it is not a lender of last resort, that it merely provides loans to the EFSF, which is in charge.

As a bank, the EFSF could undertake to do what it already does, namely to buy bonds on the secondary market. For this idea to work, however, the EFSF must have a firepower commensurate with the magnitudes in Table 1, and more in the likely event of a major banking crisis. In practice, this means that the ECB must agree *ex ante* to provide virtually unlimited amounts to the EFSF.

A better, and considerably cheaper procedure would be for the EFSF to guarantee all public debts, not necessarily for their full nominal amounts.<sup>3</sup> With an unlimited ECB backing, such a guarantee would require practically no purchases and would be considered by the markets as completely credible. This would of course limit potential losses to the bonds already purchased.

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<sup>3</sup> In fact, some governments will not recover market access unless they reduce their debt burdens through partial defaults. The guarantee *must* therefore be partial.

## 7. CONCLUSION

Along with the bailout by governments, the May 2010 decision by the ECB to get involved has radically transformed the situation. Had it refused to contribute to the bailouts, the ECB would have accelerated the unavoidable sovereign defaults, but it would have extricated itself from subsequent pressure. In effect, the ECB took responsibility for preventing defaults. In other words, the ECB has set itself as lender of last resort. Economists and historians will debate whether this was fateful mistake or not, the fact is that the ECB cannot turn the clock back. Once the Greek crisis has been "europeanized" with the ECB's active support, subsequent efforts at denying any role as lender of last are counterproductive.

The ECB has mistakenly tried to hide behind the EFSF, whose resources are not sufficient, and will not be sufficient unless the EFSF is deeply transformed. One solution for the ECB is to step forward, act as a lender of last resort by providing a guarantee to existing public bonds. Another solution is to use the EFSF as a fig leaf by granting it a banking license and providing it with unlimited financing by the ECB.

It follows that we do not need an ESM or any other form of European Monetary Fund. We need discipline to be firmly, credibly and durably established in the euro area. Unless this is done, the euro will disappear. Once this is done, there is no reason to have a rescue fund.





DIRECTORATE GENERAL FOR INTERNAL POLICIES  
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

# The ECB, the ESM and Stability Bonds: A Way Out of the Crisis

**Stefan COLLIGNON**

## NOTE

### **Abstract**

The Euro Area is on the brink of a melt down unless urgent action is taken. The paper looks at the constraints on the EFSF and for ECB interventions, which limit the capacity to bail out Member States. The issue of Eurobonds could solve some of these issues, although the Commission' Stability Bonds may take to long for their realisation. A transition proposal is made, that would give both the EFSF and the ECB a constructive role in overcoming the crisis.

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## EXECUTIVE SUMMARY

The Euro Area is on the brink of a meltdown. Political mishandling of the European debt crisis has undermined investors' trust and confidence that holding their wealth in Southern European government bonds is safe. Not surprisingly they are selling their investments *en masse* and when bond prices collapse, yield spreads explode. This is not a conspiracy by markets against the euro, but the rational response to policies which seem to ignore the external effects of Member State's actions.

At the core of the crisis stands Europe's economic governance, or rather non-governance. Policy decisions are made by autonomous Member States, which seek to maximise the utility of what they take to be their national interest, given what others do. But as is well known from Game Theory, the strategic interactions of several autonomous decision makers can generate stable equilibria that are not Pareto-optimal. In other words, what Member State governments are doing may seem to be rational from a national perspective, but it damages the interests and welfare of all European citizens. In the European debt crisis, the welfare losses result from the fact that uncoordinated government declarations affect financial markets negatively.

These external effects must be re-internalised by institutions that take into account the general interest. At the moment, we have two institutions that are able to do so: the ECB and the EFSF; the latter is to be succeeded by the ESM in 2012. The job of the ECB is to provide liquidity to the banking system; the task of the EFSF is to provide liquidity to Member States, which have lost access to financial markets. The functions and interests of these two institutions are therefore different. The ECB is independent; the EFSF is funded or guaranteed by Member States. In their desire to minimise financial costs to tax payers, Member States are tempted to shift the liquidity provision function for sovereign bonds to the ECB. By doing this, they undermine the ECB's independence. Hence, the present discussions about the roles, relationships and challenges of the ECB, the EFSF and the ESM, reflect a power struggle between member states and the ECB that will determine the future fate of the European Monetary Union.

In this briefing paper, I will first summarise the institutional arrangements, give an explanation for the euro crisis, then assess the role of the EFSF and the ECB and conclude on the provision of liquidity by the EFSF through Eurobonds.

## 1. THE INSTITUTIONAL FRAMEWORK

In Spring 2010, concerns about the debt position of Greece, followed by Ireland, and later also by Portugal, led to the drying up of capital markets for sovereign borrowers. To prevent a major financial crisis, the European Union and its Member States have provided financial support to distressed Member States, who were facing problems in meeting their international and domestic payment obligations. They granted loans first to Greece, then to Ireland and Portugal, on the condition that these Member States implement closely monitored programmes of economic adjustment. The purpose of these financial bailouts was to restore market confidence in the sustainability of public debt in these countries by correcting their financial and fiscal imbalances and allow them to return to financial markets at reasonable prices. An important element in the crisis fighting mechanism was the provision of special financial facilities (European Commission, 2011: pp. 17-20). Four instruments must be distinguished in this context.

### 1.1. The European Financial Stability Mechanism (EFSM)

The legal basis for the EFSM is article 122 TFEU and the Council regulations no. 407/210 of 11 May 2010. The EFSM is a tool by which the Commission can borrow on financial markets on behalf of the Union under an implicit EU budget guaranty. The Commission then lends the proceeds to the beneficiary Member States with no servicing costs for the Union. The EU budget guaranty guarantees the payment of the bonds in case of default by the borrower. It has a budget of EUR 60 billion.

### 1.2. The European Financial Stability Facility (EFSF)

This is a new institution set up after the European Council meeting in May 2010. Its objective is to provide loans to the Euro Area Member States with difficulties in accessing the primary market, to recapitalise banks when needed and to intervene in the secondary markets.<sup>1</sup> The EFSF is a *société anonyme* incorporated in Luxembourg, which borrows in financial markets with the guarantees of the Member States of the Euro Area other than the countries that receive aid from the EFSF (stepped out guarantors). The EFSM was authorized to borrow up to EUR 440 billion in funds guaranteed by Euro Area Member States to which the EUR 60 billion of the EFSM should be added and additional funding to the International Monetary Fund of at least EUR 250 billion was secured as a safety umbrella for distressed Member States. This meant that the crisis mechanism created in May 2010, amounted to total funds of EUR 750 billion. In September 2010, the highest possible rating was assigned to the EFSF by all three rating agencies (Standard & Poor's, Moody's and Fitch), although this required credit enhancement of 120%, over-guaranty and additional cash reserves (EFSF, Newsletter 3, 2011). While support for Greece was provided from the EFSM, the first Euro Area Member State to use the newly established EFSF facility was Ireland in November 2010. The total Irish package of financial assistance amounted to EUR 85 billion. On 7 April 2011, Portugal also negotiated a rescue package, which was formally agreed in May 2011, amounting to EUR 78 billion, of which EUR 26 billion were financed under the EFSM, another third by the EFSF, and the final third by the IMF. All these rescue packages were conditional on fiscal consolidation strategies and adjustment programmes.

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<sup>1</sup> [http://www.efsf.europa.eu/attachments/efsf\\_guideline\\_on\\_interventions\\_in\\_the\\_secondary\\_market.pdf](http://www.efsf.europa.eu/attachments/efsf_guideline_on_interventions_in_the_secondary_market.pdf)

The EFSF has already had two lives. The original EFSF (EFSF-1) was decided in May 2010 and set up in June 2010. However, it quickly became apparent that in order to obtain a AAA rating for bonds issued to finance the EFSF, cash guarantees had to be given, which handicapped the fund's lending capacity.

In December 2010 it was agreed that the initial EFSF was to be amended in order to increase the guaranty commitments from the initial amount of EUR 440 billion to EUR 780 billion. This increased the lending capacity to EUR 440 billion. The new structure of the EFSF was signed by Member States in July 2011 and was ratified by Slovakia as the last of the 17 Member States on 13 October 2011. For the new version EFSF-2, credit enhancements were changed from the initial 120% over-guaranty plus cash reserves plus non specific cash buffer to a uniformed 165% over-guaranty (EFSF Newsletter 2, 2011). The new credit enhancement structure ensures the triple AAA rating, confirming the EFSF as a quality issuer on international debt markets. It makes the structure more efficient as the borrower countries no longer need to deduct the cash reserve and loan specific cash buffers from the amount of the loan, which was necessary under the previous structure.

Two new key elements have been introduced by the EFSF-2: first, a lower interest rate on EFSF loans as the new lending rate will comprise only EFSF funding cost plus operational cost; secondly, extended maturities from the current average of 7½ years to a minimum average of 15 years and up to 30 years. In addition to providing loans to Member States, the EFSF is now also authorized to intervene in primary and secondary markets although only on the basis of ECB analysis recognizing the existence of financial market circumstances and risks to financial stability. It may also finance the recapitalization of financial institutions through loans to governments including non programme countries (EFSF Newsletter 3, 2011).

### **1.3. The European Stability Mechanism (ESM)**

In December 2010, the European Council agreed to the creation of a permanent crisis mechanism, the ESM. It will replace the EFSM as a permanent intergovernmental institution. Its objective is to provide loans to the Euro Area Member States and may exceptionally intervene in debt primary markets. Financial assistance to Euro Area countries will be under strict conditionality and includes private sector involvement in accordance with IMF practices, namely case by case analysis of debt sustainability, collective action clauses for all new Euro Area government bonds after June 2013, and preferred creditors status, junior only to IMF loans (EFSF Newsletter, January 2011).

The Treaty on the ESM was signed by the 17 euro Member States in July 2011. It should become effective in 2013<sup>2</sup> after ratification by national Parliaments. Its establishment is based on Article 136 TFEU. The ESM will be set up as an International Financial Institution (IFI) under international public law located in Luxembourg. The function of the ESM is to mobilize funding and provide financial assistance during critical times to Euro Area Member States, subject to strict policy conditionality and macroeconomic adjustment programmes. The highest decision body of the ESM will be the Board of Governors consisting of the Ministers of Finance in the Euro Area with the European Commissioner for economic and financial affairs and the President of the ECB as observers. The Board of Governors will take decisions by mutual agreement (unanimity) regarding the granting of financial assistance, the terms and conditions, and the lending capacity of the ESM. All other decisions will be taken by qualified majority.

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<sup>2</sup> This date was advanced by the December 2011 European Council to 2012

The ESM will be one of the largest International Financial Institutions in the world. Its subscribed capital will be EUR 700 billion and its lending capacity will be ensured by establishing the appropriate mix between paid in and callable capital. Its capital structure will comprise EUR 700 billion of authorized capital of which EUR 80 billion will be paid in capital (phased over 5 years in equal instalments) and EUR 620 billion of callable capital. The lending capacity will be formally reviewed on a regular basis. The ESM will lend at fixed or variable rates; pricing will take into account the debt sustainability of recipient countries while remaining above funding cost with an adequate market for risks in line with IMF pricing principles (European Commission 2011).

#### **1.4. The ECB's unorthodox policies**

Since the collapse of Lehman Brothers and the ensuing Global Financial Crisis, the ECB has used a number of unorthodox policy measures in order to ensure sufficient liquidity in the European banking system. These measures were necessary in order to preserve the ECB's technical capacity of maintaining price stability. The two main tools were the Covered Bond Purchase Programme (CBPP) and the Securities Markets Programme (SMP). The aim of the CBPP was to support a specific financial market segment that was important for the funding of banks particularly affected by the financial crisis. The purchases under the programme were EUR 60 billion and were terminated by 30 June 2010.

Following the May 2010 European Council meeting, the Governing Council of the ECB decided on 10 May 2010, on several measures to address severe tensions in financial markets. In particular, it decided to conduct interventions in the Euro Area public and private debt securities markets (Securities Markets Programme) to ensure depth and liquidity in those market segments that were dysfunctional. The objective was to restore the proper functioning of the monetary policy transmission mechanism, and thus to guarantee the effective conduct of monetary policy oriented towards price stability in the medium term. The impact of these interventions was sterilised through specific operations aimed at re-absorbing the injected liquidity and thereby ensuring that the monetary policy stance was not affected.

On 8 August 2011, the ECB signalled that it would expand its SMP to include the bonds of Spain and Italy. At that occasion, it also said that it "considers fundamental that governments stand ready to activate the European Financial Stability Facility (EFSF) in the secondary market, on the basis of an ECB analysis recognising the existence of exceptional financial market circumstances and risks to financial stability, once the EFSF is operational."<sup>3</sup> It emphasised that the SMP and EFSF mechanisms were designed to get the euro through the crisis so that fiscal reform could take place in a more orderly fashion.

To summarise, these four policy tools are all designed to deal with the severe liquidity crisis which has occurred as a consequence of the Global Financial Crisis. It is important to understand this crisis correctly, if one wishes to implement proper policies.

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<sup>3</sup> <http://www.ecb.int/press/pr/date/2011/html/pr110807.en.html>

## 2. THE NATURE OF EUROPE'S DEBT CRISIS

There are two views to look at the European debt crisis. For the *fundamentalists*, the debt crisis is caused by lack of discipline in sticking to the principles of “a sound and competitive macroeconomic base and solid public finance” (Weidmann, 2011). European governments, particularly in the South, are said to have borrowed excessively in the past, and now they are no longer able to sustain such policies. Hence, the remedy is to implement “painful reforms” and consolidate budgets, which would rebuild trust and confidence in financial markets (Issing, 2009). If the Stability and Growth Pact did not prevent excessive borrowing, new and tighter rules need to be set up, which could go as far as kicking Member States out of the Euro Area.

For the *monetarists*, the European debt crisis is the consequence of a liquidity shock. A liquidity shock starts when there is a drop in the fundamental value of securities in the market. This event may lead to the net selling of these assets and therefore to a fall in bond prices and therefore an increase in bond yields as well as increases in volatility. When no one wants to buy these assets, liquidity dries up. As asset prices fall, banks' balance sheets deteriorate and reduce bank capital (Chacko et al. 2011). This could cause a bank run. But even if deposits are guaranteed by governments, banks must reduce their liabilities, lend less and the resultant credit crunch spills over into the real economy. Low demand and falling investment will then slow down growth or even cause a recession. A vicious downward spiral reduces government income and re-enforces the debt crisis. Thus, a small local liquidity shock can lead to a global systemic financial crisis when the need for liquidity spills over to banks, and this danger is the greater, the higher the degree of integration.

A liquidity crisis can be stopped by a lender of last resort that buys up the excess supply of illiquid papers, thereby preventing the crisis from turning into a default avalanche. This excess supply consists of “old” securities, which risk adverse investors dump in the secondary market, and of new securities issued in the primary market. For monetarists, the danger in a liquidity crisis comes from the *collapse of asset prices in the secondary market* because of the distortions it produces for banks' balance sheets. By contrast, the fundamentalist approach focuses essentially at *reducing the excess supply of new securities* by stopping highly indebted states from borrowing more. While monetarists would agree that balancing budgets is part of a medium term strategy to restore stability, they also argue that if the cause of the crisis is a liquidity shock, the focus on fiscal consolidation alone and deficit reduction is insufficient and needs to be complemented by a lender of last resort capable of stopping the vicious spiral with disastrous spillovers into the real economy.

What kind of crisis is Europe's debt crisis? Table 1 shows the relative importance of public debt in the Euro Area and beyond. For the Euro Area the total outstanding public euro debt is EUR 8.1 trillion. The USA and Japan carry a debt stock of over EUR 10 trillion, each. Public debt per person is lower in Europe than in the USA (with the exception of Ireland) and Japan. However, with respect to deficits, the situation is different. The Euro Area borrowed in 2011 EUR 437.7 billion, while the US deficit is more than twice as much and Japan's is only two thirds. Thus, the Euro Area's overall debt performance should be more sustainable than in the USA if one considers new borrowings and also more sustainable than in Japan if one looks at the debt - GDP ratio.

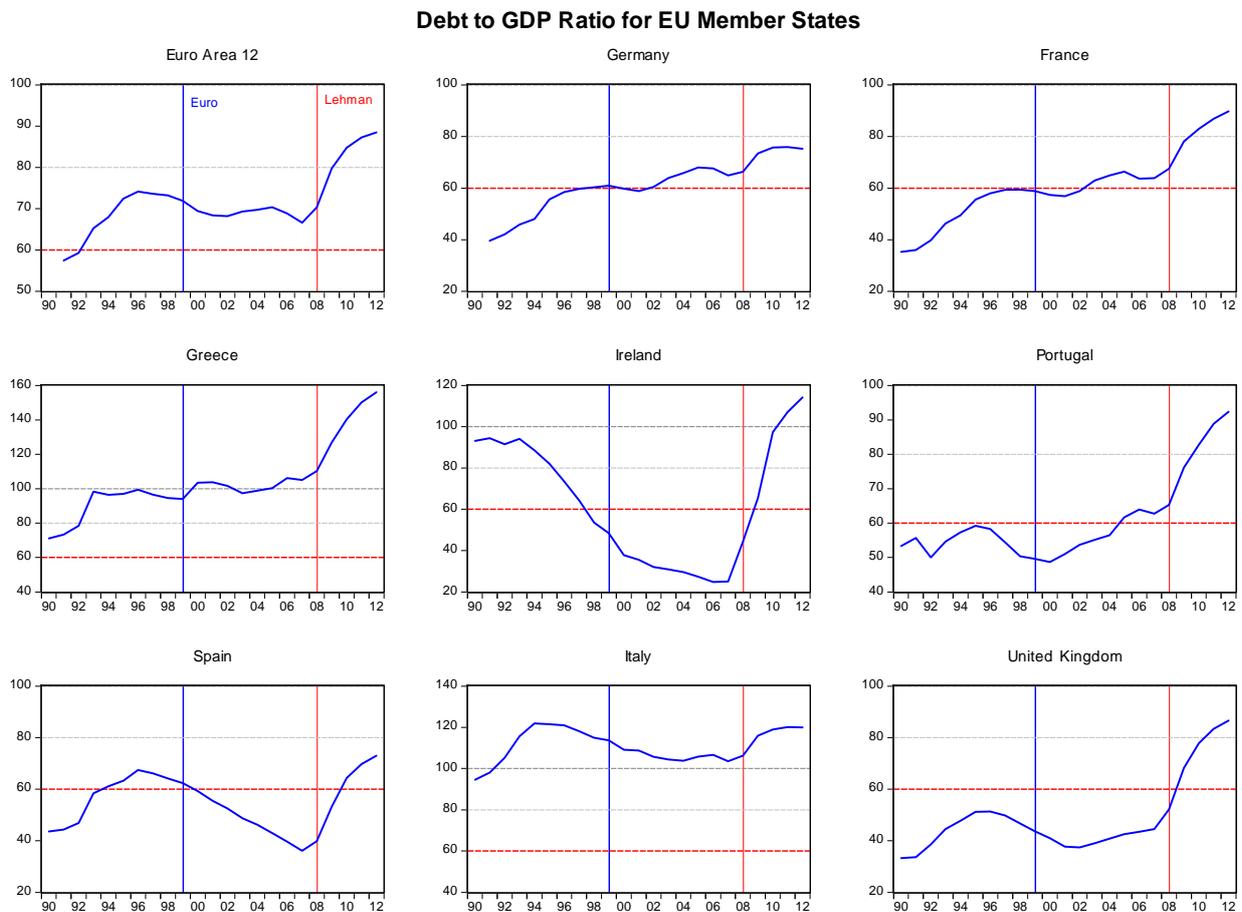
The relative weight of debtors is unequally distributed. With nearly EUR 2 trillion outstanding debt, Germany is Europe's biggest sovereign debtor with a share of 24.1%, followed by Italy (23.6%) and France (21.5%). Greece's public debt of EUR 340 billion represents only 4.5% of total debt in the Euro Area. With respect to new borrowing, France exceeds all others. The annual deficit for 2011 is estimated to be EUR 126.8 billion, nearly as much as Germany and Italy combined. Greece is expected to borrow EUR 16.8 billion, which represents a share in new borrowing well below its share in the outstanding debt stock. This is also true for Italy, but not for Spain, Ireland or Portugal. It is also of interest that among the non-euro Member States, the UK borrows far more than any other euro member, including France.

Table 1. Public debt and deficits of euro area Member States								
	Debt				Deficit			
	debt in 2011 €bn	country share %	debt per head €thousands	Debt-to-GDP level in 2007	absolute change 2011-07	relative change 2011-07 in %	deficit in 2011 €bn	country share %
<b>Euro area 12</b>	<b>8107.1</b>	<b>100.0</b>	<b>24.5</b>	<b>66.6</b>	<b>21.9</b>	<b>32.9</b>	<b>-427.7</b>	<b>100.0</b>
Germany	1955.9	24.1	23.9	64.9	10.3	15.9	-69.6	16.3
<b>Italy</b>	<b>1912.3</b>	<b>23.6</b>	<b>31.5</b>	<b>103.6</b>	<b>16.3</b>	<b>15.7</b>	<b>-68.4</b>	<b>16.0</b>
France	1746.7	21.5	26.8	63.8	26	40.8	-126.8	29.6
<b>Spain</b>	<b>745.4</b>	<b>9.2</b>	<b>15.9</b>	<b>36.1</b>	<b>36.9</b>	<b>102.2</b>	<b>-68.4</b>	<b>16.0</b>
Netherlands	402.1	5.0	24.2	45.3	22	48.6	-23.5	5.5
Belgium	367.1	4.5	33.9	84.2	17.9	21.3	-16.8	3.9
<b>Greece</b>	<b>340.2</b>	<b>4.2</b>	<b>29.9</b>	<b>105</b>	<b>51</b>	<b>48.6</b>	<b>-16.8</b>	<b>3.9</b>
Austria	209.4	2.6	24.9	59.3	14	23.6	-10.5	2.4
<b>Ireland</b>	<b>169.7</b>	<b>2.1</b>	<b>37.9</b>	<b>25</b>	<b>89.3</b>	<b>357.2</b>	<b>-16.3</b>	<b>3.8</b>
<b>Portugal</b>	<b>152.6</b>	<b>1.9</b>	<b>14.3</b>	<b>62.7</b>	<b>29.7</b>	<b>47.4</b>	<b>-8.4</b>	<b>2.0</b>
Finland	96.2	1.2	17.9	35.2	17.8	50.6	-3.0	0.7
Slovakia	31.5	0.4	5.7	29.6	17.8	60.1	-3.7	0.9
Slovenia	16.6	0.2	8.2	23.4	24.2	103.4	-2.0	0.5
Cyprus	11.9	0.1	14.7	58.3	10.1	17.3	-1.0	0.2
Malta	4.5	0.1	0.0	61.7	9.2	14.9	-0.2	0.0
Estonia	1.4	0.0	1.1	3.7	8	216.2	-0.3	0.1
		<i>relative to EA</i>	<b>debt per head</b>	<i>relative to EA</i>	<i>relative to EA</i>	<i>relative to EA</i>		<i>relative to EA</i>
United Kingdom	1474.3	18.2	23.5	44.5	42.1	94.6	-152.5	35.6
Poland	200.8	2.5	5.3	45.0	14.6	32.4	-22.8	5.3
Sweden	151.2	1.9	16.3	40.0	-2.5	-6.3	-0.4	0.1
Denmark	115.4	1.4	20.9	27.3	21.9	80.2	-10.4	2.4
Hungary	75.0	0.9	7.5	66.1	15.5	23.4	-4.4	1.0
Czech Republic	66.0	0.8	6.2	29.0	16.2	55.9	-7.0	1.6
Romania	42.2	0.5	2.0	12.6	21.5	170.6	-6.1	1.4
Lithuania	12.0	0.1	3.7	16.9	31.4	185.8	-2.0	0.5
Latvia	9.7	0.1	4.4	9.0	47.6	528.9	-1.5	0.3
Bulgaria	7.6	0.1	1.0	17.2	3.6	20.9	-1.1	0.3
United States	10764.9	132.8	34.5	62.4	39.7	63.6	-970.7	227.0
Japan	10132.3	125.0	78.7	187.7	37.5	20.0	-291.7	68.2

Source: Ameco and ECB

Figure 1 shows that public debt in Europe exploded with the Global Financial Crisis after the Lehman bankruptcy in 2008. Prior to this event, the debt ratios were falling for Spain, Ireland and Italy, and stable in Greece; they did increase in Germany and France. For the Euro Area as a whole, the debt-GDP-ratio did come down, although only at a slow pace. It can be argued that the reductions were insufficient given the economic boom of the first euro-decade. Especially the property booms in Ireland and Spain, probably also in Greece due to the Olympic Games, generated unsustainable revenue, but France and Germany also did not use the favorable growth environment to reduce their debt. No doubt, the Stability and Growth Pact has failed to restrain member states.<sup>4</sup> In this respect, the fundamentalists are right to insist that Europe’s fiscal policy framework needs to be tightened up.

**Figure 1.**

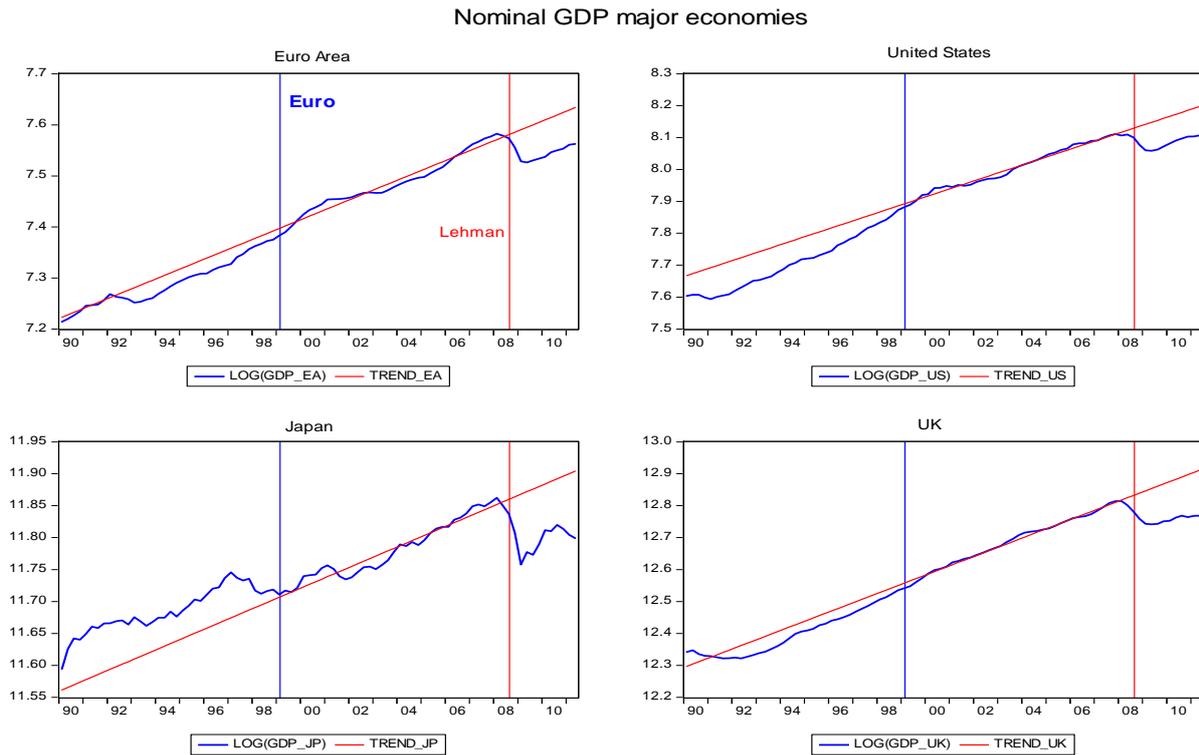


Source: AMECO

<sup>4</sup> I have argued elsewhere that this “lack of discipline” is unavoidable in a monetary union with many autonomous governments. See Collignon, 2003.

However, a major factor in the European debt crisis has been the dramatic recession and subsequent slow growth. With the important drop in global output (see Figure 2), which has affected all Euro Area Member States, public revenue has fallen in the same proportions as GDP,<sup>5</sup> while expenditure had continued to grow at previous rates. This negative growth has contributed to a deterioration of the primary deficit (the deficit net of debt service), but it has also accelerated the snowball effect, which occurs when interest rates exceed the growth rate.

**Figure 2.**



Source: EUROSTAT

Under these circumstances, a consolidation of budget deficits is necessary. However, the accelerated speed of deficit reduction is counterproductive. The harsh austerity programs have failed to reduce public debt ratios, because all drivers of growth have been blocked. Portugal's economy is contracting and Ireland only manages to grow because of booming exports to Germany's chemical industry. The most obvious failure of austerity is Greece, where GDP has fallen between 2009 and 2011 by 10%, the capital stock by 30.3% and the stock of capital equipment by even 50%. Domestic demand has shrunk by 17.5% and the only positive contribution to growth has come from a tiny increase in net exports (in essence because of a reduction in imports). Nominal wages have been cut and employment is down. Unemployment has risen by over 50%. Under these conditions, the debt ratio increases unabatedly and it seems absurd to suggest that Greece's austerity programs could stabilize its public finances. See Table 2.

<sup>5</sup> The income elasticity of government revenue relative to GDP is close to 1. See European Commission, 2011.

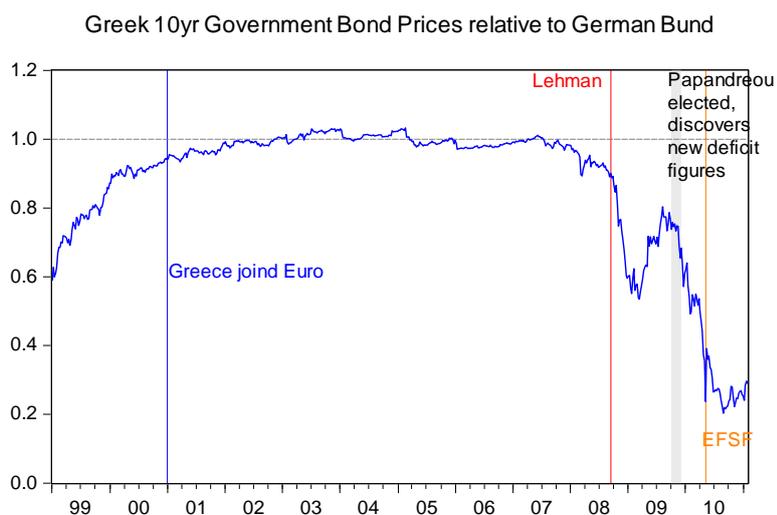
**Table 2. Macroeconomic aggregates: Greece***Annual percentage change*

	<b>1992-06</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2009-11</b>
GDP	3.0	4.3	1.0	-2.0	-4.5	-3.5	1.1	<b>-10.0</b>
Private consumption	3.1	2.8	3.2	-2.2	-4.5	-6.4	-2.2	<b>-13.1</b>
Public consumption	3.1	8.2	1.5	10.3	-6.5	-2.6	0.1	<b>1.2</b>
Gross fixed capital formation	4.3	5.5	-7.5	-11.2	-16.5	-2.6	0.1	<b>-30.3</b>
- of which: equipment	8.6	22.3	6.6	-11.8	-23.5	-16.0	-1.9	<b>-51.3</b>
Exports	6.3	5.8	4.0	-20.1	3.8	10.7	6.9	<b>-5.6</b>
Imports	5.8	9.9	4.0	-18.6	-4.8	-8.4	-3.1	<b>-31.8</b>
<i>Contribution to GDP growth</i>								
- domestic demand	3.4	4.6	1.0	-1.8	-7.7	-8.0	-1.8	<b>-17.5</b>
- inventories	-0.1	1.6	0.5	-2.3	0.9	-0.5	0.3	<b>-1.9</b>
- net exports	-0.4	-2.0	-0.5	2.0	2.3	5.0	2.6	<b>9.3</b>
Wages (compensation per head)	7.9	6.1	7.0	3.6	-3.5	-1.0	0.1	<b>-0.9</b>
Unit labour cost	6.0	3.6	6.2	5.0	-1.1	-0.1	-0.9	<b>3.8</b>
Employment change	1.2	1.7	0.2	-0.7	-2.1	-2.6	0.1	<b>-5.4</b>
Unemployment rate	9.9	8.3	7.7	9.5	12.6	15.2	15.3	
<b>Change in debt</b>	<b>27.7</b>	<b>-1.1</b>	<b>5.3</b>	<b>16.5</b>	<b>13.4</b>	<b>10.0</b>	<b>5.8</b>	<b>39.9</b>

Source: European Commission, 2011

The effect of the Greek adjustment program reveals a deeper problem with Europe's fiscal rules. The Stability and Growth Pact stipulates specifically that the "corrective arm" of the Pact is suspended when a Member State's economy shrinks by more than 1.7%. However, it does not give criteria for suspending the suspension. Presumably the corrective procedures are put back into motion as soon as the critical GDP-shrinkage has stopped and growth returns. But this is too early, as it implies that budgets now have to be adjusted to the lower output level. This early adjustment will prevent growth and output from returning rapidly to its normal steady state. Furthermore, lower investment and employment will impair long run growth. Hence, if a large part of the deficit is caused by a revenue gap after a severe output shock, it might be more appropriate to smoothen the adjustment over time. A simple rule to achieve this would be to freeze nominal expenditure until the pre-shock output level has been reached again and let the deficit adjust endogenously during this period. Once the previous GDP level has been surpassed, the ordinary preventive and corrective mechanisms of the SGP should be fully implemented again.

Acknowledging the institutional failure of the Stability and Growth Pact does not prevent us from recognising that the European debt crisis shows all the signs of a liquidity shock that originated in Greece and has spilled over into other Member States. The Greek shock was a combination of the economic deterioration after Lehman and the loss of confidence after the newly elected Papandreou government revealed that its predecessor had reported wrong data about Greek debt and deficits. Investors were therefore no longer willing to hold Greek bonds and the bond price relative to Germany collapsed (see Figure 3). This set into motion the vicious downward spiral of declining asset prices, which led to the complete freezing of the Greek bond market and spilled over into other Southern Member States. Not surprisingly, rating agencies have repeatedly downgraded euro Member States where the possibility of GDP contraction puts the sustainability of public debt in jeopardy.

**Figure 3.**

**Source:** BLOOMBERG

The correct response to this crisis would have been an immediate bailout of Greece at the beginning of the crisis and the injection of liquidity into a dysfunctional market in order to prevent the vicious spiral from developing. However, the conflict between fundamentalist and monetarist policy makers has prevented swift action. In fact, discordant political statements have deepened the crisis by creating a climate of uncertainty and increased volatility, which have accelerated the sell-off of southern European public bonds. Collignon, Esposito and Lierse (2011) have shown that political communication explains a significant contribution to the rising yield spreads between Greece and Germany. In the short run, every time the German Chancellor, Mrs. Merkel has made a declaration on Greece, uncertainty measured by the volatility of spreads has increased and this higher volatility has required higher returns on bonds from Greece. However, over the longer run, there was a direct effect whereby Merkel's statements seem to reduce the yield spread. Thus the picture is one of chaotic cacophony that irritates markets (and citizens), while in the end sound policies prevail. The price for this political inefficiency is high in terms of credit risk and credit cost (see Figure 3).<sup>6</sup>

<sup>6</sup> Our estimates suggest that Merkel's uncooperative attitude at least in the early period of the crisis, did cost Greece up to EUR 170 million. If her behaviour is a proxy for the cacophony of Europe's intergovernmental governance system, the cost for Europe's South (Greece, Italy, Spain, Portugal, Ireland) would be between EUR 1 and 1.6 billion every time Mrs Merkel talks about Greece. Given that our estimates record approximately 70 such declarations, the aggregate cost of Merkel's communication is close to EUR 100 billion. See Collignon, Esposito and Lierse (2011)

### 3. THE IMPACT OF THE EFSF

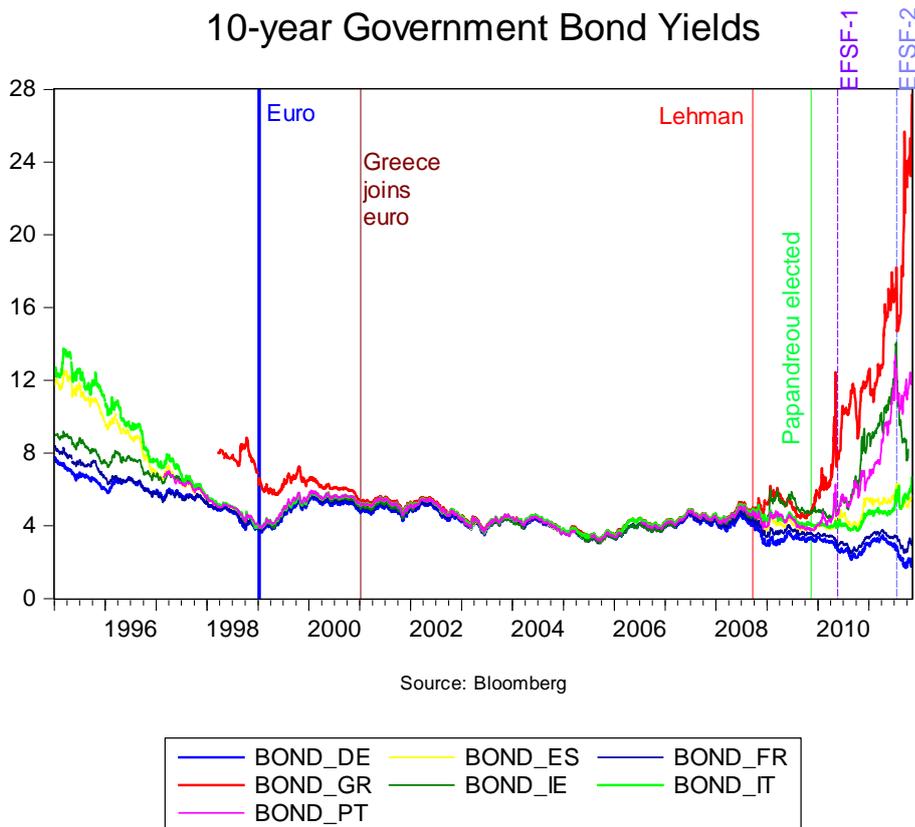
The May 2010 European Council saw the monetarists' arguments prevail. It was finally recognised that the European Treaty allowed liquidity bailouts, even if Art. 125 TFEU prohibited the assumption of debt.<sup>7</sup> The EFSF was set up to provide liquidity to Member States which had lost access to financial markets when issuing new debt. The European Central Bank followed up on 10 May by starting the Securities Markets Programme in order to stabilise the secondary market. However, it was too little, too late. When financial crisis contagion spilled over into large Member States, especially into Italy in 2011, but also into Spain and even into France, it became obvious that the original EFSF bailout fund was insufficient. In July 2011, the European Council meeting increased the fund's resources from the initial amount of EUR 440 billion to EUR 780 billion. Yet again, this was not enough. Given that Italy has to refinance approximately EUR 350 billion in 2012, there are large liquidity risks for lenders and the European Council agreed in October 2011 to leverage the EFSF up to EUR 1 trillion. By mid-November it seemed again that this has failed to quiet markets as is clear from the yield spreads on government bonds (Figure 4).<sup>8</sup>

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<sup>7</sup> Art. 125.(1) TFEU says: „The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.“ Hence, the prohibition concerns assuming liabilities by another state, which means one country's liability becomes another country's liability. By contrast, making loans increases liabilities for the borrower and generates assets for the lender. The argument that the EFSF breaks the Treaty provision of “no bailout” confuses assets and liabilities. The Maastricht Treaty prohibits, rightly or wrongly, a “federalization” of member state debt of the kind that took place in the United States in 1792, when Alexander Hamilton “assumed” state debt by the federal government in order to stabilize financial markets, but it does not prevent governments from making loans to other governments.

<sup>8</sup> A similar picture is drawn by the prices for CDS. See Collignon, 2011

Figure 4.



One reason for this failure is the power struggle between member states and the ideological conflict between fundamentalists and monetarists. The fundamentalists in the strong economies of Europe's North (especially in Germany, the Netherlands and Finland) seek to minimize their contribution to the different bailout funds, as this exposes their taxpayers' funds to potential defaults. They therefore emphasize correcting economic fundamentals and resist intervention. From a national point of view, this is rational behavior. However, the aggregate effect is the under-provision of bailout funds that prevents stopping the vicious downward spiral in bond markets. This is a typical collective action problem, which occurs when many independent decision makers have incentives to behave uncooperatively. The literature in political economy has shown that delegation to a single decision maker is the most efficient way to cut short of such problems. Hence, the Euro Area would need to delegate decision making to a non-intergovernmental European government.

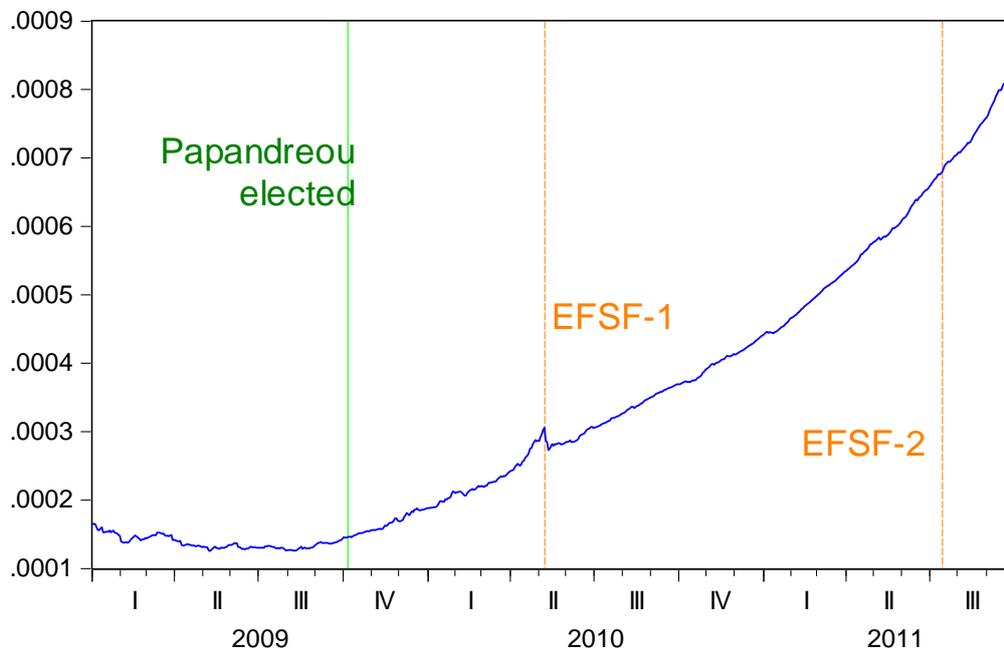
A correlate of the fundamentalist ideology is "Private Sector Involvement" (PSI). While member state governments first promised that Greece will not default, they have forced banks in October to write off "voluntarily" part of Greece's outstanding debt. This was a fantastic shot in the foot. Financial operators took this as a warning that similar conditions could be imposed on other sovereign debt in the future. They consequently unloaded their portfolio holdings, thereby further accelerating the collapse of bond prices and generating a genuine run out of European debt. PSI has also closed the door to leveraging the EFSF, for promises by member state governments are no longer credible and risk adverse investors shy away from holding European sovereign bond. By now, the flight out of the euro is so generalized, that the euro is losing value in exchange markets, despite the structural weaknesses of the US economy and the problems in Japan. In other words, the euro's

function as the alternative reserve asset in the global economy is vanishing rapidly, because member State governments impose dysfunctional policies.

The deteriorating trust in the euro can also be measured by the political noise generated by policy makers who cannot agree on what to do. Collignon (2011) gives measures of such noise by the conditional variance of the daily change of the euro's external value in a GARCH-M model.<sup>9</sup> Figure 5 reproduces the graph. It is remarkable to see how uncertainty and loss of trust by international investors has risen continuously and exponentially since the Papandreou government took over in Greece. Furthermore, the creation of the ESFS in May 2010 only had a very short term effect on reassuring markets. The transformation to the second generation of the EFSF in July 2011 had no effect on the growing uncertainty in the Euro Area.

**Figure 5.**

### Political uncertainty reflected in the USD/euro rate



Source: Collignon, 2011

<sup>9</sup> A GARCH-M model estimates a time series' mean as a function of the conditional variance.

## 4. THE ROLE OF THE ECB

The two conflicting views between fundamentalists and monetarists resemble the debates in the 1980s between *economists* and *monetarists* regarding the preconditions of monetary union. At the time, economists, mainly in Germany, emphasized the need for economic convergence prior to starting monetary union, monetarists believed that money will endogenize the adjustment process. The conflict was finally overcome by the Delors Committee, which proposed the creation of an independent centralized monetary authority, the ECB, and the convergence in economic fundamentals by stipulating criteria, the later Maastricht criteria, which ensured fundamental convergence in economic performance.<sup>10</sup> The solution of Europe's debt crisis may require a similar compromise between long term fiscal consolidation and short term liquidity management. How could such a way out of the crisis look like? Restoring trust in the euro must, first of all, take the noise out of the policy debates. At the present moment, this noise is fuelled by the conflict of interest between Germany, France and the ECB about who should bail out liquidity-constrained sovereign debtors: Governments through the EFSF or the ECB?

Governments try to minimize their exposure to bailouts, although there are important conflicts between national strategies. Germany, as the main voice of fundamentalism, insists on the need for fiscal discipline in order to reduce the supply of new debt titles for which there is little appetite from financial investors. This seems to be in the German national interest as it would reduce the potential liabilities of the EFSF in case a bailout country defaulted. However, this view of national interest ignores the externalities of underprovided funds and the resultant rise in general uncertainty that will damage German interests in a much broader sense. Furthermore, Germany can only sustain this position because it has significant competitive advantages over all its neighbours which help keeping German deficits relatively low.<sup>11</sup> France, on the other side, has lost the advantage accumulated by decades of *competitive disinflation* policy. Over the last five years it has masked the important deterioration of its competitiveness<sup>12</sup> by excessive deficits – borrowing roughly as much as Germany and Italy together. As the Euro Area is now becoming increasingly more likely to enter a recession, this high borrowing is turning into a debt problem for France. French sovereign debt is on the brink of being downgraded from AAA, which undermines its capacity to bail out other Member States. Hence the French government would like to push the bailout away from the EFSF into the ECB.

The alternative to Member States providing liquidity through the EFSF, and later through the ESM, is to ask the ECB to be the *buyer of last resort* for government bonds. Monetarists argue that Europe is now in a systemic liquidity crisis which has spread to most Southern sovereigns. In this situation, contagion between sovereign bond markets can only be stopped if the central bank is willing to be the lender of last resort that guarantees that cash is available to pay out bondholders (de Grauwe, 2011). According to their view, only the ECB has the "firing power" to buy all bonds which the private sector does not wish to hold. The argument boils down to saying that the central bank could issue unlimited liabilities, i.e. money. This proposal has been fiercely resisted by fundamentalists, especially in the German government and in the Bundesbank. Their fear is that monetizing public debt could undermine price stability and even lead to hyperinflation (Weidman, 2011).

<sup>10</sup> See Collignon and Schwarzer, 2003, for details.

<sup>11</sup> The German budget law for 2012, which was voted by the Bundestag in November 2011, is proof, however, that German policy makers find it as difficult to consolidate in a boom as any other policy maker in Europe, including the least responsible ones.

<sup>12</sup> See CER, 2011 and Collignon 2012 forthcoming.

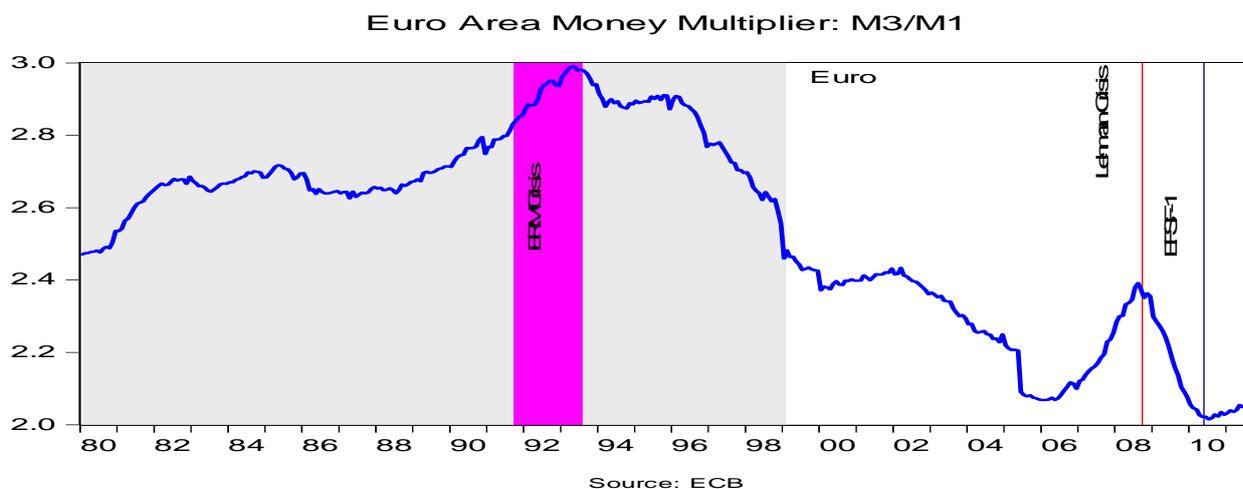
However, the two positions focus on different aspects. The monetarist lender-of-last-resort camp only looks at the short run; the fundamentalists emphasize the long run. How to pass from here to there is rarely discussed.

The ECB's mandate sets price stability as the primary objective of monetary policy, but it also explicitly mentions the need for maintaining financial stability. The central bank's independence is necessary in order to fulfill this mandate. The Bank must keep control over all instruments, which allow the proper conduct of monetary policy. The unorthodox methods are necessary to ensure that the orthodox transition mechanism, namely interest rates, can function correctly. However, if the ECB were to buy debt by Member States which would subsequently default, it could lose its capacity to act in accordance with its mandate. It would sit on a pile of liabilities (base money), which it could no longer recall. The ECB must therefore resist pressures by Member States and financial markets to become the unlimited buyer of last resort for sovereign debt. The fear by fundamentalists is not without grounds, as can be seen from the monetarist claim that in countries capable of issuing debt in their own currency, "central banks can always provide the liquidity to the sovereign to avoid default. This may lead to future inflation, but it shields the sovereign from a default forced by the market" (de Grauwe, 2011b: 32).

This debate resembles the classic conflict in monetary theory between horizontalists and verticalists (Moore, 1988). Horizontalists claim that money supply must be perfectly elastic (the supply curve of money is a horizontal line at any interest rate), while verticalists insist that the central bank needs to keep money supply tight and highly inelastic in order to prevent inflation (the supply curve of money is a vertical line at any amount of base money). The missing link between the two positions is the transmission from base money to broad money aggregates. Because central banks use the price for liquidity, i.e. short term interest rates as their main policy instrument, they must accommodate with perfect elasticity the demand for base money at that price. Otherwise, they could not sustain that interest rate. However, broad money (M3), which is relevant for determining the price level of goods and services and the rate of inflation, depends on bank deposits, which are liabilities for banks. Yet, these deposits are created by bank loans, so that loans make deposits and it is the demand for loans at a given equilibrium for liquidity preference and interest rates that makes the broad money supply vertical. Hence it is important that the ECB maintains financial stability in the banking system in order to preserve the interest rate as the policy instrument for controlling inflation. In the present crisis, this may require unorthodox methods of liquidity provision in the short term money market, but also stability in long term bond yields and their differentials between Member States.

The relationship between central bank money (M1) and broad money (M3) is reflected in the money multiplier. If the central bank could control broad money supply and inflation by variations of base money, the ratio of M3/M1, which is called the *money multiplier*, would have to be stable. However, if broad money is responding to interest rates and liquidity preference, the money multiplier would vary according to economic conditions. Figure 6 shows significant fluctuations in the size of the multiplier. A fall in the ratio indicates an increase in liquidity preference by the banking sector, a rise signals generous liquidity provision. From the time of the crisis of the Exchange Rate Mechanism (ERM) in 1993 until 2005, liquidity preference has tended to rise. From the mid-2000s until the Lehman crisis in 2008, banks were little concerned by liquidity constraints, despite the monetary tightening by the ECB. After the Lehman crisis, liquidity became very tight, but interestingly, after the set up of the EFSF the situation has improved slightly. However, it is quite clear that the creation of central bank liquidity through sovereign bond purchases has not had any substantial inflationary effect.

Figure 6.

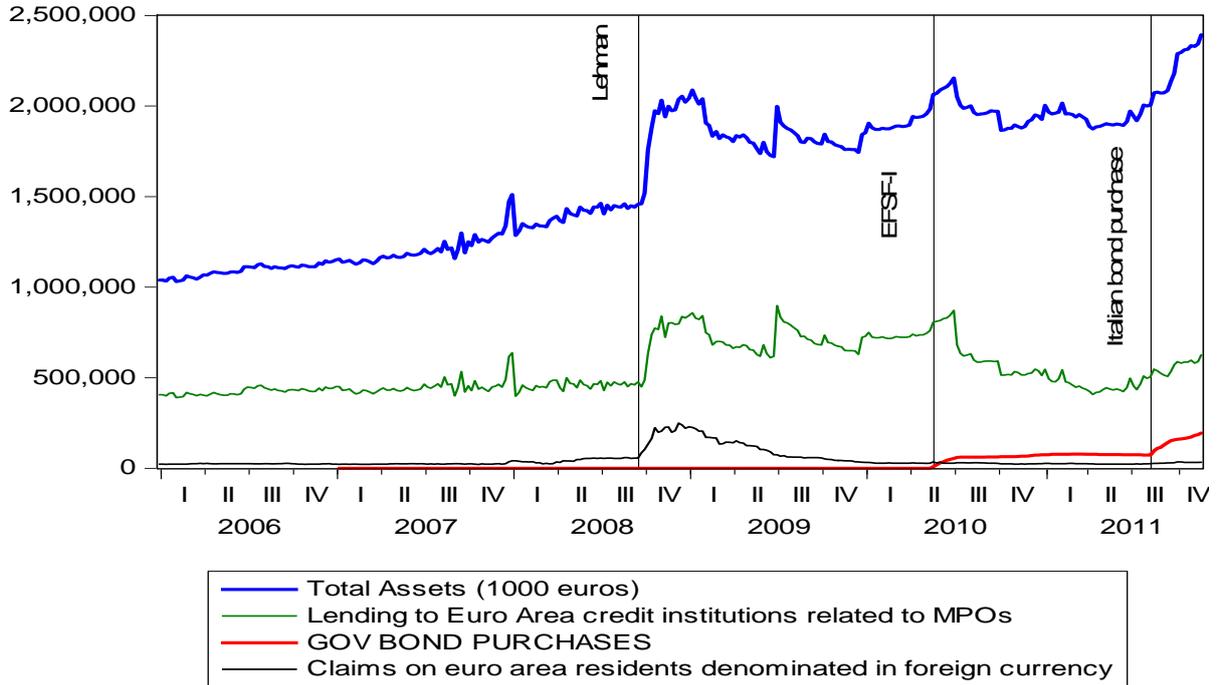


This raises the question, whether the ECB could intervene at a larger scale and buy sovereign debt of Southern European member states without the risk of igniting inflation. So far, the ECB has taken a restrained approach: it has bought only a modest amount of government securities and it insists that it is fulfilling its mandate of maintaining price stability over the medium run, because it keeps money supply under control by "sterilizing" its interventions. Dullien and Joebges (2011) found that the ECB purchases of government debt were sterilized at the rate of 50 percent. Sterilization means that, to the degree that the ECB buys government bonds, it will sell other assets, domestic and foreign, which will keep base money supply stable. Hence, as long as the ECB has sellable assets other than government bonds, the risk of excessive liquidity creation can be eliminated. Thus, open market operations in government securities are not automatically inflationary. Nevertheless, the capacity of the ECB to buy government bonds, i.e. its firing power, is not unlimited and the constraints on a non-inflationary bailout depend on the balance sheet of the central bank. In this respect the fundamentalists are right to emphasize that a central bank's reputation takes long to be built up, but trust is easily and quickly lost.

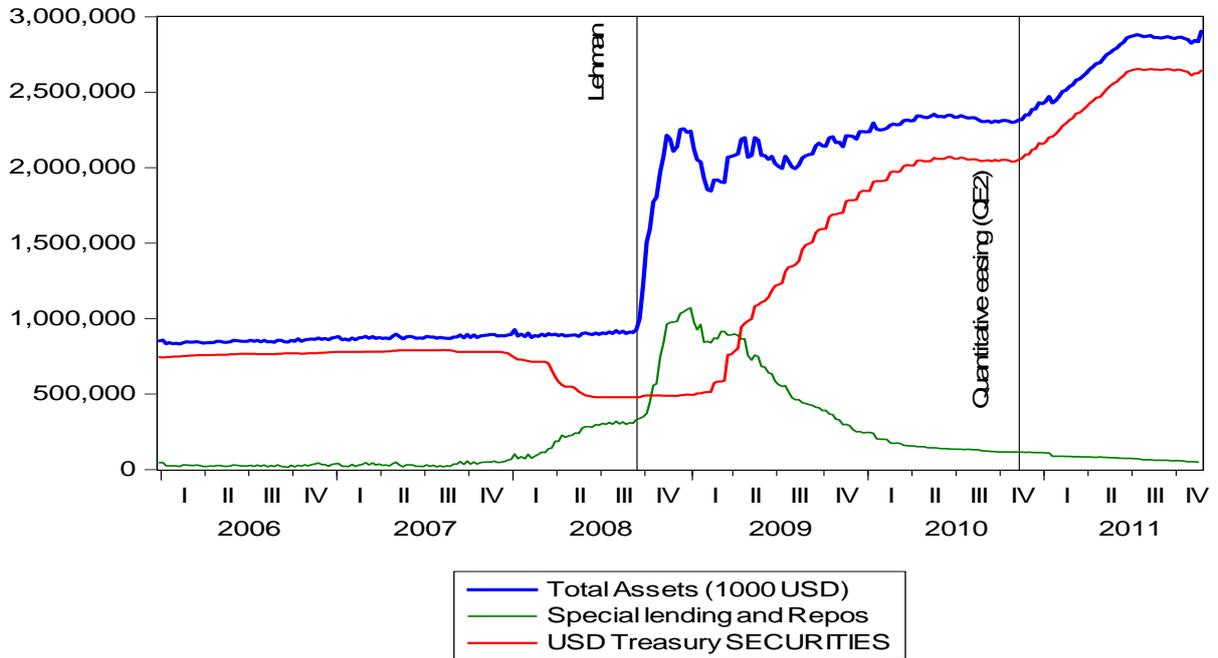
How large are the constraints on government bond purchases by the balance sheet of the ECB? Figure 7 shows the balance sheets of the ECB (Eurosystem) and the Federal Reserve System. The total assets of both central banks have greatly increased after the Lehman default. In the US, the Fed first reacted by using repos to provide liquidity to the banking system, but then replaced them by open market purchases of Treasury bonds. In Europe, government bond purchases only occurred after 10 May 2010, but with approximately € 200bn they remain rather insignificant relative to the total ECB balance sheet of nearly € 3 trillion.

Figure 7.

### ECB Balance Sheet



### FED Balance Sheet



Source: Bloomberg

The weak impact of the SMP for the euro economy is also clear when we compare the volumes to GDP. Table 3 shows that before the Lehman crisis, total assets of the Eurosystem were nearly twice as high as in the USA; as a response to the crisis, the Fed balance sheet tripled, but only doubled in Europe. Public debt held by the Fed was 5.6 % of GDP before the crisis, but stands now at 17.7 %. By contrast, the ECB ratio of public debt to GDP is still only 2.5% . Given that total outstanding debt is 84% in the Euro Area and 92.8% in the USA, the monetized part of public debt is 2.9% in Europe and 19.1% in the USA. If the ECB would buy European bonds up to a share comparable to the Federal Reserve, it would generate nearly EUR 1500 billion, which is close to a third of total base money supply M1. This volume would leave a sufficient reserve for sterilisation and control of base money. The EUR 1500 billion are the reasonable “firing power” for ECB interventions in the secondary market for European government bonds.

**Table 3. Central Bank Dimensions in % of GDP**

<b>Total assets (% GDP)</b>	<b>ECB</b>	<b>FED</b>
Before crisis (June 2007)	13.1	6.2
After crisis (November 2011)	26.1	19.4
<b>Central Bank: gross public debt in balance sheet (% GDP)</b>		
	<b>ECB*</b>	<b>FED**</b>
Before crisis (June 2007)	0.4	5.6
After crisis (November 2011)	2.5	17.7
Share of monetized debt to total	2.9	19.1
Memo:		
National gross public debt in 2010	84.1	92.8
* Public debt owned by Euro Area national central banks + SMP		
** Federal Agencies debt is included		
<b>Source:</b> Bloomberg		

Nevertheless, there is an important difference between buying US Treasury bonds or Greek and Italian debt titles. The first are considered riskless, the later highly risky. Buying risky assets is contrary to conventional central bank practices. A central bank is the “bank of banks”. It provides liquidity to the banking system against adequate collateral and sound counterparties. A long tradition in central banking, going back to 300 years experience in the Bank of England, emphasises that as the bank of banks, the central bank can only fulfil its function as the *lender of last resort*, if its assets are of top quality. Otherwise banks would switch their deposits to other more secure banks, such as foreign banks, where wealth can be held in strong currencies.<sup>13</sup> Because modern central banks’ liabilities are legal tender, this switching process may become inelastic, but that does not change the fact that risk-averse investors would avoid holding deposits in a bank that is not trustworthy. In addition, the risk of holding assets, which may become worthless, reduces the ECB’s capacity to reduce base money through selling assets in the open market or even through issuing Sterilisation Bonds as Dullien and Joebges (2011) suggest.

<sup>13</sup> This may be the reason why emerging market central banks often hold a large part of their assets in foreign currency. Clearly, this is not an acceptable perspective for the European Central Bank.

From the beginning, the ECB has therefore insisted that it only lends to banks against “good” collateral, although, under pressure from markets and uncooperative Member State governments, it has now started to buy risky sovereign bonds. Nevertheless, its main instrument remains the *repurchase agreement*, also known as a *repo*, which is the sale of securities together with an agreement for the seller to buy back the securities at a later date. This policy tool allows control over monetary base. Contrary to the American Federal Reserve System, the ECB has not made frequent use of outright purchases and sales of securities through open market operations (OMO). One reason may be that the Fed can use the deep and liquid Treasury bond market for OMOs, while the ECB does not have an equivalent market for risk free Eurobonds. If one would like to use the ECB’s “firing power” to intervene in the sovereign bond market, the Euro Area would need to have a “good quality” asset that represents the aggregate strength of the Euro Area. Hence, the ECB would need to be able to use Eurobonds.

## 5. STABILITY BONDS AS A WAY OUT OF THE LIQUIDITY CRISIS?

After lengthy debates about the risks and benefits of Eurobonds, the European Commission (2011b) has now produced a Green paper on the feasibility of introducing *Stability Bonds*. This closes a gap, for until now the modalities of creating Eurobonds were never clear. The Commission proposes three options for the issuance of joint Stability Bonds:

1. The *full substitution* by Stability Bond issuance of national issuance, with *joint and several guarantees*: this approach would replace the entire national issuance by Stability Bonds and as each Member States would be fully liable for the entire issuance.
2. The *partial substitution* by Stability Bond issuance of national issuance, with *joint and several guarantees*: this option would only cover parts of national financing needs. Member States would continue issuing their own bonds, although at an accordingly lower volume due to the parallel issuance of Stability Bonds. Hence, Member States would still need to tap financial markets on their own and would be subject to market and financing conditions that would vary across Member States and might reflect their different credit quality.
3. The *partial substitution* by Stability Bond issuance of national issuance, with *several but not joint guarantees*: This approach is the most limited one of the three options. It would be relatively rapidly deployable. Some additional safeguards, i.e. "credit enhancements" would be necessary, for example in the form of collateral provided by Member States. This approach would have certain similarities to bonds issued by the European Financial Stability Facility (EFSF). However, whereas the latter are meant to step in and help financing vulnerable Member States in the context of the sovereign debt crisis, Stability Bonds would be instruments available to all Euro Area Member States and also outside any crisis context. Their volume and potential effect on market efficiency and integration would be accordingly much larger.

The advantages of such bonds are described by the Commission as follows:

1. They could quickly alleviate the current sovereign debt crisis, as the high-yield Member States could benefit from the stronger creditworthiness of the low-yield Member States
2. They would make the euro-area financial system more resilient to future adverse shocks and so reinforce financial stability.
3. They would improve the effectiveness of euro-area monetary policy.
4. They would promote efficiency in the euro-area sovereign bond market and in the broader euro-area financial system.
5. They would facilitate portfolio investment in the euro and foster a more balanced global financial system

However, there are also a number of open questions. The joint issue of European bonds would require much stronger fiscal surveillance procedures and policy coordination than the present Stability and Growth Pact. This is in any case desirable, as the crisis has shown that the previous arrangements were insufficient. Also, especially option 1 and 2 are incompatible with the present Art. 125(1) TFEU and would require a Treaty change.<sup>14</sup> The Commission also emphasizes that "Stability Bonds should be designed and issued such that

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<sup>14</sup> See footnote 7.

investors consider them a very safe asset. Stability Bonds would need to have high credit quality to be accepted by investors and by those euro-area Member States that already enjoy the highest credit rating".<sup>15</sup>

No doubt, any of the three options would be a significant step forward in the governance of Europe's fiscal policy. Stability Bonds could make a real difference in restoring trust and confidence in financial markets that the European Union has the political will to continue and survive (which is presently vanishing rapidly). The main problem with the proposed Stability Bonds is that it will take a long time until they could come into existence. Even if the opposition by the German Chancellor could be overcome, Treaty changes will take a long time. A quick and short term transition to one of the three described scenarios is needed.

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<sup>15</sup> Information for this chapter taken from:  
<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/820>

## 6. A TRANSITION SCHEME FOR STABILITY BONDS

The proposed options 1 and 2 are clearly the arrangement most compatible with an integrated financial market and a currency with the potential of being the second global reserve currency. In terms of the debt crisis, member states subject to high yields and high risk premia would benefit from the creditworthiness of low yield member states. Under option 2, the Commission refers to the Delpla and von Weizsäcker (2010) idea of blue and red bonds, reflecting a unionization of debt up to 60% of national GDP. This leaves still an important fraction of non-unionized debt outstanding which could perpetuate the European debt crisis. One could imagine alternatively a more functional distinction whereby all central government debt is unionized, while lower level public debt remains individually issued.

For practical purposes, option 3 is the most realistic in the short run. However, its capacity to mitigate the sovereign debt crisis in the Euro Area is limited, as the Commission (2011:18) recognizes: "In the absence of any credit enhancement, the credit quality of a Stability Bond underpinned by several but not joint guarantees would at best be the (weighted) average of the credit qualities of the euro-area Member States. It could even be determined by the credit quality of the lowest-rated Member State, unless they enjoy credible seniority over national issuance in the case of all Member States (see below). This could reduce the acceptance of the instrument among investors and among the higher-rated Member States and undermine the benefits of Stability Bonds, notably their resilience in times of financial stress." The enhancement essentially boils down to providing seniority to the debt servicing of Stability Bonds. However, while under normal conditions, the total cost of debt for a country should remain constant or fall, the marginal cost of the debt would rise. This makes it harder for Southern European member states to maintain the sustainability of their debt.

An additional enhancement for option 3 could overcome these difficulties and allow a rapid transition to full Stability Bonds. It consists in unionizing an important part of today's outstanding public debt and enhancing the quality of the Stability Bonds by issuing them as asset backed securities.<sup>16</sup>

In this context, the EFSF would act as the centralized debt management office which issues Stability Bonds as its liability against a portfolio of national bonds, which it buys in the secondary market. In my previous proposals, I suggested that the portfolio should aim at shares of national debt reflecting the shareholding in the ECB. However, in the present circumstances of crisis management this seems no longer necessary, although for distributional purposes it may be desirable in the longer run. It is, however, important that the quality of the assets underlying these Stability Bonds justifies AAA rating. This requires that the EFSF buys a large share of the outstanding German, French, Dutch bonds in addition of Greek, Portuguese, Irish and Italian Bonds. Table 1 has shown the proportions of outstanding European debt. If one would aim for swapping 60% of the national debt of Greece into Stability Bonds in such a way that Greek bonds represent the 2.8% in the ECB's share capital, the total volume of the Stability Bonds to be issued by the EFSF would be EUR 7177 billion, i.e. the degree of unionization would be 88.5% of the total outstanding debt in the Euro Area. For Italy, which has a higher share in the ECB capital, the unionization degree would fall to 78.2% for a total Stability Bond portfolio of EUR 6343 billion.<sup>17</sup>

<sup>16</sup> The idea builds on my earlier proposals of Union Bonds, which were inspired by the ECU as a precursor of the euro. See Collignon, 2011b and 2011c.

<sup>17</sup> These amounts are calculated like this: the unionization degree is  $x/d$ , where  $d$  is the amount of outstanding debt of the Euro Area.  $x$  is 60% of a member state's outstanding debt, divided by the ECB share capital.

This transitional arrangement of Stability Bonds issued by the EFSF would create very quickly a deep European bond market, without imposing additional costs to low yield member states. A further advantage would be that by combining high and low yielding assets in a tradable portfolio, Stability Bonds would be of investment quality without Member States having to commit to additional guarantees, which could impose potential burdens on tax payers in Northern Europe.

Finally, it would be possible for the ECB to buy these Stability Bonds outright from banks or to use them as collateral in monetary policy operations (repos and OMOs) without the EFSM needing a banking license. If the ECB bought these Stability funds to an amount of up to EUR 1500 billion, it would still leave approximately EUR 5000 billion in the hands of private investors, who would, however, regained trust and confidence in European bonds. The ECB has substantial, but not unlimited power to stabilize financial markets, although it needs a deep Eurobond market to intervene.

## **7. CONCLUSION**

The euro is under existential threat, but there are still a few options to save it. Unless member state governments quickly act and create Stability Bonds, which replace risky sovereign bonds, panic in financial markets will destroy the accomplishment of 50 years of European integration.

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**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
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# **How To Back Up the Rescue Fund?**

**Daniel GROS**  
**Thomas MAYER**

## **NOTE**

### **Abstract**

More and more investors are anticipating the unravelling of the euro area because the 'leveraged' European Financial Stability Facility (EFSF) cannot work as intended. This note argues, however, that if the EFSF (and the European Stability Mechanism or ESM) was registered as a bank – which would give them access to potentially unlimited ECB re-financing in case of need – the generalised breakdown of confidence could be stopped while leaving the management of public debt under the supervision of the finance ministers.

The current version of the ESM Treaty would already allow a refinancing of the ESM via the European Central Bank (ECB).

There is no danger for price stability under this approach, as the ECB could still manage liquidity while the 'EFSF/ESM-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 be compatible with the Treaty's prohibition of monetary financing.

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## LIST OF ABBREVIATIONS

- ECB** European Central Bank
- EFSF** European Financial Stability Facility
- EFSM** European Financial Stability Mechanism
- EIB** European Investment Bank
- EMF** European Monetary Fund
- EMU** European Monetary Union
- ESM** European Stability Mechanism
- GDP** Gross Domestic Product
- IMF** International Monetary Fund
- KfW** Kreditanstalt für Wiederaufbau
- MFI** Multilateral Financial Institution
- PSI** Private-Sector Involvement
- QE** Quantitative Easing
- SMP** Securities Markets Programme

## EXECUTIVE SUMMARY

Countries are vulnerable to 'runs' on their public debt markets owing to the fact that they have only long-term assets (the capacity to levy taxes from their citizens), but short-term liabilities because even without running a deficit they have to refinance a sizeable proportion of their overall debt each year. The fiscal authority of any country that loses the confidence of the financial markets (and cannot print its own currency) can thus quickly run out of funding and thereby become insolvent if investors go on strike. Something like this seems to be happening right now in the euro area where investors are unsure about the value of government bonds. Banks used to be able to hold them without any capital charge. But suddenly the capital charge has effectively been increased to 100%, following the decision of October 26<sup>th</sup> to require banks to achieve a 9% core capital ratio after marking their holdings of government debt to market. Moreover, the private sector involvement (PSI) enforced on Greek debt combined with the ambiguous language in the European Stability Mechanism (ESM) Treaty have created doubts about the value of peripheral government debt in general.

The current panic seems to be feeding upon itself and has led to a generalised lack of liquidity. It makes sense for the authorities to intervene and stabilise markets under these circumstances. The basic idea proposed here is thus quite simple: there is a liquidity problem, which can only be solved with the support of the only institution that can create at least potentially unlimited amounts of liquidity, namely the European Central Bank (ECB). However, there is always a fiscal risk in this type of operation, which is why the finance ministers need to be involved as well. The simplest solution would thus be for the European Financial Stability Facility (EFSF) to take the decision on interventions in the secondary market and rely on the ECB for liquidity, if needed, by conducting normal repo operations with the ECB, like any normal bank.

### *Addendum on very recent developments*

As it has become apparent that the 'leveraged' EFSF will not work, there have been calls to rely on the International Monetary Fund (IMF). However, the effectively available lending capacity of the IMF is only about EUR 300 billion and many emerging economies would be extremely reluctant to allocate all of this to a group of countries that is among the richest of the world, the euro area, and that, when taken together as a single entity, does not have a balance-of-payments problem. One way to circumvent this reluctance would be for the ECB to provide the IMF with the required funds to lend to Italy and Spain. This would effectively be the same approach as the one proposed here – but it might be politically more acceptable in some member countries. (A little known fact is that the IMF is primarily financed by 'monetary financing', i.e. by drawing on loans from national central banks.)

As an aside, one has to note that the IMF would be hard pressed to provide Italy with the required hundreds of billions of euro, given that the quota of Italy in the IMF is only about EUR 50 billion. However, if all member countries of the euro area were to 'pool' their IMF quota, which is above EUR 200 billion, they could, collectively, at least theoretically qualify for a very large precautionary loan.

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## 1. INTRODUCTION<sup>1</sup>

The current crisis is usually referred to as the 'euro crisis' or the 'euro sovereign debt crisis'. However, in reality this 'euro' crisis is just a general manifestation of a much more general phenomenon, namely the bust that follows an excessive credit expansion fuelled by a general absence of risk aversion. When risk aversion returned with a vengeance in 2007-2008 it first concentrated on financial markets (securities based on US subprime mortgages and later towards all financial institutions that might have some of these 'toxic' securities in their portfolios).

But, as usual after a credit bubble bursts, the risk aversion later also engulfed public sector debt because public debt levels increased everywhere due to the big recession, but also due to the need for governments to transform private debt into public obligations.

The euro area is particularly vulnerable to the return of risk aversion towards public debt given that each individual government is effectively indebted in a 'foreign' currency and no government in the euro area can count on the liquidity support from a central bank.

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<sup>1</sup> The paper is based in part on the authors' Commentary entitled 'August 2011: What to do when the euro crisis reaches the core?', CEPS, 11 August 2011.

## **2. THE DEBT FEARS REACH THE CORE**

When markets were at first just unwilling to finance some peripheral countries, namely Greece, Portugal and Ireland, it was possible to provide these three countries with sufficient means from the fiscal resources of the core countries to finance their deficits and rollover needs for several years.

However, this is not possible for larger countries, such as Italy or Spain, which, by general consensus, are both 'too big to fail' and 'too big to be saved'.

### **2.1 The EFSF was designed for a peripheral crisis**

The EFSF could not deal with larger countries because its financing is structured in such a way that the burden increases on the core countries as more and more countries need financing. Moreover, the rules of the EFSF also imply that countries that need to be rescued no longer contribute to the rescue of others and one can also not expect countries that might still have market access but have to pay very high-risk premia to contribute to the financing of the EFSF.

As described in Giovannini & Gros (2011), it would be dangerous to use the EFSF for a crisis that has reached the core. They show in particular that one key domino that might fall if the EFSF were overextended is France. In recent weeks financial markets have started pricing French debt at a level that is no longer compatible with the AAA rating of the country and this has led to a perception that there is a risk of a break-up of the euro area (and with it, a breakdown of its financial system).

### **2.2 Fiscal leverage for the EFSF cannot work**

The euro area summit of October 26<sup>th</sup> promised to increase the 'firepower' of the EFSF by allowing it to provide partial guarantees for new issuance of public debt instruments by countries such as Italy and Spain. Gros (2011) shows that this approach cannot alleviate the problem and would actually make matters worse.

(We do not discuss the second approach proposed on October 26<sup>th</sup> since so far few investors outside Europe have shown interest in investing in the new vehicle whose details have not been published yet.)

### **2.3 The bank-public debt feedback loop**

Developments since the October summit have shown that a dangerous negative feedback loop can develop between weakly capitalised banks that hold large amounts of the debt of their own government and the governments themselves. A sell-off of the public debt reduces the value of the banks and the weaker banks might then depend on public support to be able to survive.

Financial markets have reacted, as in 2008, by redlining certain classes of institutions, which lose access to their normal funding sources. But when banks lose access to funding they transmit a credit crunch, which drives the economy down and thus tax revenues as well.

This vicious circle needs to be broken before it engulfs more countries. Hence we repeat our call to transform the EFSF into a true 'European Monetary Fund' (EMF).

In our view, such an EMF should have two tasks and thus two departments.

One 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.<sup>2</sup> The EFSF, as it has operated until now, would fit this description.

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 would insist on top quality in any 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 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<sup>st</sup> 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.<sup>3</sup>

Our proposal is institutionally far superior to the present arrangement, in which the ECB uses its Securities Markets Programme (SMP) to just keep markets from becoming totally dysfunctional, without, however, being able to provide investors with real insurance that Italy or Spain will indeed avoid a liquidity crisis, which would turn quickly into a solvency crisis. Moreover, the task of the ECB is to maintain price stability on average for the euro area, not to draft and supervise fiscal adjustment programmes for individual member countries.

The key problem now is one of liquidity for large economies with a manageable debt problem (and, in the case of Italy, already a primary surplus). The only institution that can provide this liquidity in the required amount is the ECB. Of course, as with all liquidity support there is always a danger that the country is not only illiquid, but also insolvent. This risk needs to be faced squarely, but not by the ECB, but by the fiscal authorities, which also take this decision if a bank has to be saved. This is why we would argue that the proper institution to decide whether a country just needs liquidity support is a body representing the fiscal authorities, i.e. the EMF (or the governing body of the EFSF). Only when the fiscal authorities have decided that a country is solvent should recourse to liquidity provision by the ECB be activated – again in close analogy to the procedure followed in the case of bank rescues.

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<sup>2</sup> The limited market borrowing capacity of the EMF would ensure that debt is restructured when adjustment has failed.

<sup>3</sup> For this paragraph see also Gros and Mayer (2011).

Many have argued that our proposal would not be consistent with the European treaties. We do not think this is the case. Article 123 (1) of the TFEU forbids direct ECB credit to public institutions in order to avoid monetary financing of fiscal deficits. However, Article 123 (2) TFEU exempts banks owned by the public sector from this prohibition. Thus, public banks such as the European Investment Bank or Germany's Kreditanstalt für Wiederaufbau (KfW), which extends Germany's share 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 from the prohibition of receiving financing from the ECB. 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 currently under discussion that would be politically and legally even more dangerous.

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### 3. CONCLUDING REMARK

We do not wish to suggest that providing the EFSF/ESM with a liquidity backstop by the ECB will solve all problems. It is clear that the crisis will require deep-seated reforms, not only for fiscal policy, but also in many other areas. But without a liquidity support, the crisis countries might simply not have enough time to implement these reforms, many of which are now being enacted quickly throughout the periphery.

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## ANNEX: LEGAL ISSUES

Some might be argued that our proposal is not compatible with the prohibition of monetary financing of public bodies, but 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 multilateral financial institutions (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, but 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 (1) TFEU. Nowhere in Article 123 (1) TFEU 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 entities from receiving ECB monetary financing.<sup>4</sup>

One could of course argue that since the EFSF is fully owned by governments, it falls under the category of 'public undertakings'. However, Article 123 (1) did not prevent the European Investment Bank (EIB – an EU body, but with a distinct legal personality, registered in Luxembourg, like the EFSF, and owned by Member States and the European 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:

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<sup>4</sup> Opponents of our proposal base their argument on the purpose for which the ECB funding to the EFSF will be used, 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.

Article 123 (2) reads:

*'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 exemption in Paragraph 2 of Article 123 TFEU, if it could be considered a publicly-owned 'credit institution'. Given that a number of investment funds are recognised as credit institutions, as mentioned above, there is no substantial reason why this should not be possible.

We note that Germany's 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 EUR 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 (1) TFEU.

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,<sup>5</sup> which exempts both the financing of the IMF and the financial assistance to non-euro-area membership from the scope of Article 123 TFEU. Given that financial assistance to euro area member states will soon also have a treaty basis (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.

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<sup>5</sup> 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.



**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

# **Political-Economic Options and Constraints for the EU Summit - ECB, EFSF and Austerity Programmes**

**Ansgar BELKE**

## **NOTE**

### **Abstract**

This paper describes the political-economic options and constraints for the December 2011 EU Summit and discusses potential causes of a non-zero probability of a breakup of the euro area. We analyse both against the background of inconsistencies of current political strategies to save the euro such as rescue packages, the EFSF, ECB bond purchases, austerity programmes and combinations of them. For this purpose, we investigate whether the fact that investors a couple of days before shunned German bonds represents a warning for the German economy and, what is more, to the current concept of the euro area as a whole. We further investigate the following questions: Are the austerity packages convincing the markets? Why does the German government reject as not effective the issue of eurobonds and also a more drastic action by the ECB in the bond market? What are the dangers of using these instruments? Is the Greek austerity package a failed "recipe" that only continues a vicious cycle? Will national parliaments and also the people across Europe accept a change of the EU treaties and giving up budgetary or even national sovereignty? Or should the EU or the euro area-17 really implement the US model of dealing with the crisis by financing debt through the central bank and printing money? Would an explicit fiscal "back-up" of the ECB serve as a ticket to "doomsday"?

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## EXECUTIVE SUMMARY

This paper describes the political-economic options and constraints for the December 2011 EU Summit and discusses potential causes of a non-zero probability of a breakup of the euro area. We analyse both against the background of inconsistencies of current political strategies to save the euro such as rescue packages, the EFSF, ECB bond purchases, austerity programs and combinations of them. For this purpose, we investigate whether the fact that investors a couple of days before shunned German bonds represents a warning for the German economy and, what is more, to the current concept of the euro area as a whole. We further investigate the following questions: Are the austerity packages convincing the markets? Why does the German government reject as not effective the issue of eurobonds and also a more drastic action by the ECB in the bond market? What are the dangers of using these instruments? Is the Greek austerity package a failed "recipe" that only continues a vicious cycle? Will national parliaments and also the people across Europe accept a change of the EU treaties and giving up budgetary or even national sovereignty? Or should the EU or the euro area-17 really implement the US model of dealing with the crisis by financing debt through the central bank and printing money? Would an explicit fiscal "back-up" of the ECB serve as a ticket to "doomsday"?

The envisaged change of the EU treaties also entails the subject of giving up budgetary or even national sovereignty. Could this be accepted not only by the national parliaments but also the people across Europe? Of course this is a foregone conclusion in a sense since it would be optimal if all financially stressed euro area Member States install a debt brake deliberately. But this will obviously not be the case for political-economic reasons, most probably so for France. Governments want to become re-elected and, hence, serve their electorate and their lobbies.

Even more important: one should take also into account that the price the AAA-rated countries would have to pay is to at least temporarily abolish the political and financial independence of the ECB and/or to accept euro bonds. However, there is no free lunch: the only way – if at all – this could be pushed through politically would be a package deal which on the one hand includes a "bank license" for the EFSF or an indirect bailout through the central banks via the IMF and/or euro bonds. But on the other hand, also – in order to make the first options work a hardened fiscal union. This is probably the only deal which could work politically.

However, the author does neither see the German population giving in to publicly support sovereign bond purchases by the ECB or granting a "bank license" to the EFSF or using the IMF to circumvent the prohibition of monetary financing public debt nor the people from the financially stressed countries accepting to deliver their budgetary autonomy to a foreign authority (The author would not expect this neither from the Germans nor from the French). Hence, whatever the deal at the summit will be, in the end there will be no credible package deal "euro bonds and/or bond purchases by the ECB combined with a fiscal union designed by Merkel and Sarkozy, embracing the right to address the European court in case of one over-indebted country breaching the rules of a hardened SGP (or at least if a national debt brake is not installed in a credible way), the installation of a stability commissioner and truly automatic sanctions if budgetary targets are missed. But this failure of a package deal might in turn in the extreme risk to put an end to the EMU project as a whole.

*“Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency” (Keynes, 1919, Chapter VI, pp.235-236)*

*“Talk of the euro zone splintering is “crazy” and European leaders need to quieten their dissonant voices which are destabilizing financial markets and threatening to tip the region back into recession” (Dawson, 2011)*

## 1. INTRODUCTION

The muddling-through approach European politicians have chosen to “solve” the euro debt crisis has failed to tackle the fundamental problems of competitiveness and other types of economic divergence within the monetary union. Since this has already continued for too long, the euro area risks to move towards disorderly debt workouts, and eventually a break-up of the monetary union itself, as soon as some of the weaker members or even the stronger members secede (Belke, 2011a, Eichengreen, 2008, Feldstein, 2007, 2008, Gros and Mayer, 2010, 2011).

The Economic and Monetary Union (EMU) fulfilled at no time of its existence the conditions of an optimal currency area. Following the old Thatcherist idea of “There Is No Alternative” (TINA) strategy, its political and economic leaders hoped that their lack of monetary, fiscal and exchange rate policies would in turn foster structural reforms (Belke, Herz and Vogel, 2006). It was hoped that the EMU would thus *endogenously* become an optimum currency area since structural reforms would lead to a convergence of productivity and growth rates<sup>1</sup>

However, the so called *endogenous optimum currency area theory* (Belke and Gros, 2002, Frankel and Rose, 1998, Krugman, Obstfeld and Méltiz, 2011) was *not confirmed* empirically by European reality. With the benefit of hindsight, we can now feel legitimized to state that, somewhat paradoxically, interest rate convergence in the early years of the euro area paved the way for a greater divergence of national fiscal policies. A reckless lack of discipline in countries such as Greece and Portugal – often more (Greece) or less (Portugal) characterized as *insolvent* - was matched only by the build-up of asset bubbles in other Member States such Spain and Ireland which like Italy have currently often been classified as *illiquid* (Gros and Mayer, 2011).<sup>2</sup>

At the same time, structural reforms were and in the case of Greece are still delayed, whereas wage growth as compared to productivity growth diverged. A huge loss of competitiveness on the periphery was the consequence (Roubini, 2011). Sovereign bond yield convergence reached around the starting date of the euro has thus in the meantime been sharply reversed. It is no longer an unthinkable imagination that *the euro might not be as irreversible* as indicated by the often stressed notion of “irrevocably freezed” intra-European exchange rates. Moreover, it does not seem completely odd anymore to imagine that one Member State or even a group of them might revert to their former national currencies. This paper argues that the latter would be a costly venture for both secessionist and the remaining countries. But at the same time it concedes the “pain threshold” to secede, although quite high, would not be insurmountable in the end (Eichengreen, 2008, pp. 47ff.). Especially since the problem pressure for some countries within the euro area has increased dramatically in the last months (Belke, 2011a, 2011b).

Garber (1998) and Scott (1998) were among the first to discuss the possibility of a euro area break-up. Eichengreen (2008) and Feldstein (2008) started to continue this discussion in the wake of the Lehman disaster after exactly a decade in which the growing problems did not come to the surface and thus any public discussion was not incentivized.

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<sup>1</sup> See Eichengreen (2008), pp. 35 ff., on reforms to avert a break-up of the euro area.

<sup>2</sup> The distinction between illiquidity and insolvency is admittedly a demanding one but has to be met when defining a critical debt share of GDP, 60 percent as in the Maastricht criteria or 90 percent according to Reinhart and Rogoff (2010) as well.

## 2. CAUSES AND MOTIVATIONS FOR A BREAK-UP

### 2.1. Is the fact that investors shunned German bonds a warning for the German economy?

On 23 November 2011, investors shunned some 35 percent of the EUR 6 billion 10-year Bund issue. However, one should not over-interpret this pattern of too low offered interest rate (according to the risk connected with them, see second paragraph) for long-term Bunds, i.e. 10-year, because in the days before traders satisfied their demands of Bunds as safe haven instruments over-proportionally. Additionally, the auction took place in a highly nervous market. What is more, the yields of short-term German bonds took negative values at the same time. This implies that traders are even paying (!) for holding a safe haven asset. One could add a technical aspect as well. Typically banks are absorbing Bunds issues in a first step which they, in a second step, pass on to other investors. The bond demand is temporarily lower, because banks are currently contracting their balance sheets.

However, if this pattern will repeat, this could well be interpreted as a sign that the crisis is heading one-way, i.e. to the direction of a *euro area break-up*. Moreover, it could be interpreted as an indication that the buyer strikes are not directed towards Germany itself but that worries are increasing that the EMU could collapse due to deteriorating market sentiment, to *policy packages which are contradictory in themselves*, shaped by huge intra-euro area political differences and lagging behind, the huge and increasing size of euro area public debt and the cascade structure of the EFSF which puts the largest burden on (still) triple-A rated Germany and makes it responsible for the excess debt of other member countries. According to this view, the latter mechanism might in turn lead to a non-sustainable increase of debt for Germany as well.

In my last briefing paper under the heading "Not too much leeway to act independently – The ECB and its political constraints" (frankly speaking, one could add "and the look into the abyss ") I dwelled on these issues – especially on the interplay of the too small EFSF (which has effectively not been leveraged up to now, see Belke, 2011a), the ECB as a lender of last resort and the structure of the "endgame of the euro" - in the necessary detail (Belke, 2011, pp. 20-24). Hence, I do not repeat my arguments in favour of a vicious circle here but only add some beef to them by adding the following sections 2.2 to 2.8.

The impression emerging from the considerations in my recent briefing paper and from the observations presented in section 2 of this briefing paper is that the *creation of winners and losers* in a currency area causes trust problems and thus is in political terms *highly infectious*. "Country A may want country B to deliver austerity but country B may take the view that country A should ultimately also have to suffer, in which case default may ultimately seem to be more attractive than austerity" (HSBC, 2011). Indeed, we end up with a euro version of the original "Prisoners' Dilemma" where, despite both prisoners knowing that a "best outcome" exists, they are only able to select an outcome that will eventually leave both of them worse off than they needed to be (HSBC, 2011).<sup>3</sup>

<sup>3</sup> HSBC (2011), p. 12, points at an illustrative historical example. The incentive to avoid "collective responsibility" is both deeply disturbing and has unfortunate historical precedent. In 1931, Creditanstalt, the Austrian bank, failed. Its collapse was closely linked to France's decision not to offer loans to support the liquidity of Austria's banking system, largely because the French were, rightly, worried that Austria's proposed customs union with Germany would conflict with its obligations under the Treaty of St Germain, the Austrian equivalent of the Treaty of Versailles.

Finally, one should take into account that politicians of course strive to be re-elected by their home base. In Germany, for instance, federal elections will take place in 2013, i.e. the year in which the ESM will be put in place. Remember that Angela Merkel lost important local elections in North Rhine-Westphalia immediately after she had agreed to the first Greek rescue package (Belke, 2011b, HSBC, 2011, p. 12). Not to forget trans-national alliances between a government A and a government B in terms of "tit-for-tat" strategies dependent on the sequence of re-election dates for both countries – the EFSF might well serve as a switching yard in this respect. In this sense the political business cycle with governments of different ideology as current incumbents and currently non-synchronized election dates in the euro area might be an additional building brick to the euro area's "frozen" status and its potential way into doomsday (Belke and Potrafke, 2011, Feldstein, 2008).

## **2.2. Are the austerity packages convincing the markets?**

Some argue that the way this crisis evolves shows that the budgetary discipline and the austerity packages that are supported by the German government are not convincing the markets and the debt crisis seems to spread. According to this popular view, the measures imposed by the Troika, i.e. a reduction of government expenditure or an increase in taxes, would be self-defeating because demand and, hence, also GDP tend to shrink as a consequence. This argument might apply in the short- to medium run to the Greek case, but certainly not for euro area core countries like Italy. Indeed, Italy may serve as counter-example in this context. In spite of the rather determined Italian fiscal adjustment in the second half of the nineties and its growth-reducing effects, the snowball factor (i.e. interest rate minus economic growth; it is called snowball factor, since this difference is positive debt is increasing even with a balanced government budget) was reduced to a significant extent for this country (Gros, 2011).<sup>4</sup> This also implies that there is no unique upper threshold for sovereign yields which should be defended by the ECB. The latter should better concentrate on rare liquidity injections for countries under a confidence and liquidity crisis and on offering enough liquidity to banks via unconventional monetary policies (Belke, 2011c, and Gros, 2011a).

## **2.3. Why does the German government reject the issue of eurobonds as not effective and also a more drastic action by the ECB in the bond market? What are the dangers of using these instruments?**

In general, the decisive question will be whether investors will feel inclined to buy euro bonds. Let us first investigate this issue more deeply.

Eurobonds could not necessarily be sold at a very low yield, which gets close to that of Bunds as the benchmark. The main argument usually is that investors would be indifferent between US and euro bonds and be keen also on the latter because aggregate debt and budget deficit levels of the euro area compare favorably with the US situation. However, I fully back Gros (2011b) in this respect and feel more skeptical the more the euro bonds are constructed to cover a major part of the outstanding debt. This is because investors have been well aware of the fact that many solutions to cope with the euro area debt crisis have been reversed and cheated upon by politicians and thus might not at all attach full credibility to the envisaged "joint and several" guarantee. What is more, investors might

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<sup>4</sup> Gros (2011) adds convincingly that "if it were true, it would follow that tax cuts would actually lead to lower deficits because higher growth would more than offset the lower tax revenues. This proposition has been tested several times in the US, but supporting evidence was never found".

well anticipate that the installment of euro bonds will cause an even faster aggregate increase of public debt in the euro area.<sup>5</sup>

The danger thus is that the cart is put before the horse, i.e. that a political union is shaped to legitimize euro bonds. But those proposing a political union to make euro bonds work start from the proposition "that some EU Treaty changes and high-level political agreements would be sufficient to make sure that euro area Member States implement all decisions taken at the European (or rather euro area) level" (Gros, 2011b). However, there are some blunt doubts in this optimistic assessment referring to the experience with the fiscal adjustment of Greece and the opposition to it by some of the Greek politicians and population has shown. Even some of my Greek colleagues from Greek and other European universities said to me that even the most self-committed Greek government was not capable of pushing through most of those austerity measures, although it was well aware of their clear necessity.

And in fact there are big differences among euro area Member States with respect to the World Bank "governance indicators" (World Bank, 2011). The degree of their fulfillment by each euro area Member State appears to be rather useful in our context because it allows comparing different countries on the quality and effectiveness of their administrations, the extent to which the rule of law is actually obeyed to and their control of corruption. All these criteria are necessary but not sufficient elements if a political union and, based on this, euro bonds are destined to truly work. However, even a quick glance at these indicators clarifies that the differences are so huge that a political union is unlikely to work, at least in the next couple of years. It directly follows that the adoption of euro bonds would take place also on very thin ice then (Gros, 2011b).

Clearly, any hypothetical introduction of euro bonds presupposes a minimum consensus and, as expressed by Gros (2011b), a "minimum common standard of political reliability" which makes sure that the population of the still more solvent Member States whose fiscal capacity is also limited can truly trust in a reliable and tough application of the imposed enforcement mechanisms on the public budget deficit each member country is granted to run. But a brief inspection of the World Bank data reveals that the performance of many of the core countries is much better than that of the financially distressed euro area Member States. What is more, this gap even widened over the last decade (Gros, 2011b).

The German government and the Bundesbank find themselves still in fierce opposition to the sovereign bond purchases by the ECB which up to now have accumulated to EUR 195 billion. Their main argument is that this way of action sets the wrong incentives for governments to reform and that it could create inflation by effectively printing money (see sections 2.6 and 2.7). One could add that the German view could be easily overridden in the ECB council due to the one-person-one-vote principle. What is more, it is not clear ex ante whether the EU Treaties really speak against sovereign bond purchases. One could argue that this action has been taken in order to re-install a functioning monetary transmission mechanism which in turn serves to maintain the main target of achieving price stability. But one should not forget that public German opposition could make this venture quite costly because the former would lead to speculative attacks to test the ECB's commitment to upper ceilings for sovereign bond yields. The latter gives Germany significant power to push through tough steps towards strengthened euro area governance.<sup>6</sup>

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<sup>5</sup> Gros (2011b) adds that "Market participants might also attach higher sovereign credit risks to the euro area in view of its high level of bank debt which is more than double as high than in the US".

<sup>6</sup> Atkins (2011) makes this important point.

## The German “no” to euro bonds

Most leading German economists have said “Nein” to eurobonds. Yet, economists of the likes of Joseph Stiglitz and investors of the caliber of George Soros see the issuing of eurobonds as the only way to save the euro area. Are they wrong? No, at least not generally. Eurobonds are not a bad idea in general but their benefits are “path-dependent”. If the general picture would be that the euro area Member States overall are in a favorable public debt situation, the issue of eurobonds up to, for instance, the often proposed 60% of GDP would, seen on the whole, satisfy the funding needs of the euro area countries. What is more, the Member States in this case could profit from a rather tiny liquidity premium by introducing eurobonds. Since private investors would most probably be junior in case of government insolvency, they would demand a too high yield which in turn would not grant the countries to issue much additional debt. But, admittedly, the default risk of the Member States would be diminished. Before envisaging the introduction of eurobonds as an option for the euro area, public debt has in the first instance be diminished sustainably on an individual country basis (and not on average across all Member States). But this is neither macroeconomic reality in the euro area as it stands nor is it credibly on the official agenda, at least for the time being.<sup>7</sup>

What is more, I am not satisfied by the way the notion of eurobonds is coined in the current debate. It is unnecessarily vague. But all variants bear the danger of introducing a political union without having any democratic legitimacy.

One prominent “eurobond” proposal is to create “joint and several liability for euro area countries’ debt. But holding tax-payers fully and unconditionally liable for spending decisions taken in other countries would most likely prove to be harmful for EMU” (Gros and Mayer, 2011). It is surprising for me to see that politicians so often under-estimate the probability that political resistance against EMU would rise in the stronger countries.

This in turn might eventually lead to a probable break-up of EMU, also because not everybody in Germany sees in this case a dramatically rising external value of the Deutsch Mark as insurmountable hurdle for ongoing export success (see sections 3 and 4). Additionally, this approach would make a change in the EU treaties necessary. Finally, it would probably not be compatible with the German constitution.

The advantage of a much larger and more liquid market, created by eurobonds, compared to national bonds seems to me quite limited. The potential savings in terms of improved liquidity should amount to not more than 30 to 50 basis points, with an eye on the fact that the interest rates on sovereign bonds of a large AAA-issuer, e.g. Germany, and the small AAA-issuer Austria which represent similar high-quality sovereign bonds differ by only this small amount.

I also don't believe, that eurobonds offer significant advantages in terms of risk pooling. This is because presently euro area risks are so unevenly distributed to the disadvantage of the periphery and are also highly correlated among peripheral countries. As often argued, they are exposed to similar shocks such as low growth or higher interest rates. This is clearly at odds with simple theory of finance: “any joint issuance of bonds should lower the credit risk relative to the average risk of national bonds only if the risks that individual members incur were not too dissimilar and not too closely correlated” (Gros, 2011c). Governments should know that – as so often in economics – unfortunately do not dispose of any free lunch. The gains of debtor countries would be compensated by higher borrowing costs and lower interest income of creditor countries.

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<sup>7</sup> For the following passages see Belke (2011b) and Gros (2011c).

But eurobonds would not even be able to unilaterally lower interest rates for countries such as Greece, Ireland, Portugal and Spain for which lower rates are so vital right now. To get a grip on this, just look at the common features of the eurobond proposals. They would allow euro area countries to issue bonds that are guaranteed “jointly and several” by every member up to a certain level and, even more crucially, the eurobonds would be senior to private claims. The latter are junior and in case of, for instance, Greek debt restructuring would be the last in the queue and have to come up for the losses. The value of private claims would thus fall and the costs of private refinancing for Greece would increase. Just rendering some claims senior to others would not lead to lower average borrowing costs; it just changes the debt composition. This is valid for governments as it is for firms according to the so-called Modigliani-Miller theorem in Finance (Gros, 2011c).

The main conclusion is that the introduction of eurobonds would on average reduce debt-service costs only slightly and more so in the short run. The more European bonds are issued, the more risky the current overhang of private debt becomes and the higher the borrowing costs tend to be. In the extreme, a member country might not be able to issue any private debt at all. But the other side would be an ultimate Europeanization of many important areas of economic policy, i.e. pensions, taxes, and maybe even an EU “police for financial affairs” because it is clear that otherwise the introduction of eurobonds would lead to significant moral hazard in the sense that there are no incentives for debt reduction because the more solid countries automatically have to step in for the less solid ones (Gros, 2011c, Gros and Mayer, 2011). Having in mind that euro area Member States throughout did not de facto support the mechanism of automatic sanctions for countries with excessive deficits, I would certainly not bet on their support of an even more significant sovereignty loss (Belke, 2011b).

Admittedly, also the specific German strategic perspective plays a role (in a same way as it does for other euro area countries in the “end-game” as well): Germany would have to live with higher interest rates and would in the end run the danger of losing its AAA-rating because it is made responsible for the risks incurred by countries going for over-indebtedness. The costs are difficult to calculate but are estimated to amount to a value of at least double-digit billions of euros (Belke, 2011b).

What is more, we have seen in late summer that Italy has in the end hurried to put budget consolidation programmes on track – purely as a reaction to severe pressure of financial markets but without eurobonds. Without these stepwise and dramatic interest rate increases and severe pressure by the ECB the Italian government would not have been hurrying up in the way we observed right now. It is overall important to attach a positive assessment to increasing risk premia – in contrast to the public perception. Turbulences on capital markets are important wake-up calls for politicians. Eurobonds would abandon this beneficial pressure (Belke, 2011b).

What about blue and red bonds, whereby countries would bear different levels of cost in their issuing?

If eurobonds issues were restricted to cover only a 40 to 60 percent share of public debt at GDP as envisaged, countries which are indebted to a much higher extent would instantly be urged to enter debt restructuring. The reason is that these countries – as far as their nationally guaranteed part of public debt is concerned – have become even less attractive for investors.<sup>8</sup>

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<sup>8</sup> Gros and Mayer (2011) argue that this “could be different if in case of default part of the bonds—say that consistent with a 60% debt ratio—were guaranteed by the community of euro area states (through a respective 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”.

Seen on the whole, limiting eurobonds to an amount of 60% of GDP also limits the calming down effect on financial markets. In the case of Italy, for instance, whose public debt amounts to 120% of GDP the probability of a default on debt which is not covered by eurobonds would increase dramatically. Hence, financial markets would request ever higher risk premia and would not calm down. What is more, pressure would even emerge to raise the limit for incurring debt in eurobonds. Also in the cases of Greece, Portugal and Ireland the 60% limit would not be helpful for the same reasons. Hence, markets could be only truly calmed down if the *whole amount of public debt* would be rescheduled to eurobonds. But in this case, one would *have lost control of debt* on every scale, except if one counts on a pan-European interventionist body – a “financial police” – or on the national introduction of debt brakes as a more democratic *and realistic* scenario (Gros, 2011c, Gros and Mayer, 2011).

#### **2.4. The Greek austerity package as a failed "recipe" that only continues a vicious cycle?**

Greece has gone into deep recession due to the austerity package and there are a lot of people in Greece but also in Europe talking about a failed "recipe" that only continues this vicious cycle. What about this view? Look first at Ireland. A comparison with this country might be helpful. The high Irish openness also contributes to the lowest fiscal multiplier among the peripheral economies and hence the lowest final effect of fiscal consolidation on GDP. Exports can provide a strong offset to low domestic demand, thereby reducing the political difficulties of maintaining a tight fiscal stance. This is particularly important in the current environment where the required adjustment process in the private and the public sector will lead to subdued domestic demand for a prolonged period (EU Commission, 2011).

Hence, in a sense commentators are right with respect to Ireland since current account data also suggests that the necessary deleveraging of Ireland's private sector is well underway. Ireland has run a substantial current account deficit only from 2005 to 2009. This means the economy has used more resources than it produces only for some years. Moreover, Ireland is projected to run a slight current surplus this year which is forecasted to increase to more than 6% of GDP in 2015. The Irish economy as a whole has therefore no need for additional foreign funds (EU Commission, 2011).

The situation is different in Greece. Greece experienced a strong decline in the national savings rate after the introduction of the euro. It afforded for a rather long time the lowest savings rate in the euro area. As a consequence, the current-account balance gradually worsened. Since 2000 the current-account deficit has been throughout higher than 10% of GDP. After 2004, current-account deficits contributed almost 50 percentage points to net foreign debt as a share of GDP which amounted to about 100% at end-of-year 2010. This huge debt build-up accumulated over a relatively short period of time (Corsetti et al., 2011, EU Commission, 2011).

Current account adjustment has been very slow in Greece. The current account deficit was still close to 12% of GDP in 2010, and is projected to fall only slowly to 4% in 2014 (EU Commission, 2011). The high deficit in the current account balance is “a reflection of the fact that Greece's supply-side structure is tilted towards producing non-traded goods and services. An expansion of the export sector sufficient to restore a sustainable external balance is not likely to occur soon” (EEAG, 2011). This is also because the economy's low openness implies that it needs an even bigger *real exchange-rate* depreciation in order to bring the external balance into equilibrium. “*The required adjustment will most likely have to come from a fall in imports, via reductions in wealth and income. The conclusion is that it is likely that Greece will see a number of years with output far below potential and very*

*high unemployment rates*" (EEAG, 2011). It has the *highest negative Keynesian multiplier in the whole euro area!* But in order to avoid a permanent slump, these years of austerity appear to be unavoidable. But admittedly, the haircut of Greek debt could have been, e.g., 60% instead of de facto 50% which would have made the transition easier for the Greeks.

## **2.5. The change of the EU treaties and giving up budgetary or even national sovereignty – Acceptance by national parliaments and also the people across Europe?**

The change of the EU treaties also entails the subject of giving up budgetary or even national sovereignty. Could this be accepted not only by the national parliaments but also the people across Europe? Of course, this is a foregone conclusion in a sense since it would be optimal if all financially stressed euro area Member States would install a debt brake deliberately. But this will obviously not be the case for political-economic reasons, most probably for France. Governments want to become re-elected and, hence, serve their electorate and their lobbies.

Even more important, one should take also into account that the price the AAA-rated countries would have to pay is to abolish the political and financial independence of the ECB and/or to accept eurobonds. However, there is no free lunch. The only way, if at all, this could be pushed through politically would be a package deal which includes on the one hand a "bank license" for the EFSF or an indirect bailout through the central banks via the IMF and on the other hand – in order to make the first options work - a hardened fiscal union. This is the only deal which could work politically.

However, I do neither see the German people giving in to support sovereign bond purchases by the ECB or granting a bank license to the EFSF or the IMF nor the people from the financially stressed countries accepting to deliver their budgetary autonomy to a foreign authority. Frankly speaking, I would not expect this neither from the Germans nor from the French. Hence, whatever the outcome of the December 2011 EU summit will be, in the end there will be no credible package deal, including euro bonds and/or bond purchases by the ECB combined with a fiscal union designed by Merkel and Sarkozy, embracing the right to address the European Court of Justice in case of one over-indebted country breaching the rules of a hardened SGP (or at least if a national debt brake is not installed in a credible way), the installation of a stability commissioner and truly automatic sanctions if budgetary targets are missed. But this failure of a package deal might in turn risk putting an end to the EMU project as a whole.

## **2.6. Should the EU implement the US model of dealing with the crisis by financing debt through the central bank and printing money?**

Why is the EU not implementing the American model of dealing with the crisis by financing debt through the central bank and even printing money? Germany and its current "allies" as, for instance, Finland and the Netherlands fear that this kind of policy is conveying the wrong incentives for politicians and is creating inflation in the medium to long run. Of course, the German vote could be ignored in the ECB council which still follows the one person-one vote principle when taking monetary policy decisions. However, the risk of going forward without support of these countries would be that the ECB's credibility in terms of sovereign bond purchases and its numerical targets for intra-euro area interest rate spreads would fade away. Any doubt in a 100% German support would immediately provoke speculative attacks.

In one of my former briefing papers, I argued in this context:

*"In addition, targeted bond purchases issued by highly indebted euro area governments contain an element of subsidy which tends to severely weaken their fiscal discipline: the interest rate premium on bonds of fiscally weaker countries declines and that the premium for stronger countries increases. Fiscally solid countries are punished and less solid ones, in turn, are rewarded for their lack of fiscal discipline and excess private and public consumption. The credit risk is thus just rolled over from the bonds of the weaker countries to those of the stronger ones and the ECB is made responsible for its liability"*

(Belke, 2010).

What is more, if yields are too low there is no incentive any more for private investors to invest in sovereign bonds. The countries become decoupled from the capital markets permanently and the debt problems become structural. Finally, there are severe doubts in the prolonged sterilization of the sovereign bond purchases, especially if standing facilities are offered by the ECB alongside the sterilization operations. Hence, the measures might be inflationary in the medium to long run.<sup>9</sup>

According to the ECB's homepage, its cumulated sovereign bond purchases currently amount to EUR 187 billion. The purchases are sterilized preponderantly by deposit offers to commercial banks. Alternatives to the latter are the issuance of ECB debt certificates and – very much textbook-style – sales of other assets. The ECB plays the active part in the latter operation whereas it seems to be more difficult to arrive at the targeted deposit volume. Additionally, the issuance of debt certificates tends to lower the sovereign bond prices in the euro area (Belke, 2009 and 2010). All three variants of sterilization are thus not credible as long as standing facilities are offered in parallel. The interesting question is: Are there upper bounds for sterilization?

The balance sheet total of the ECB on October 28, 2011, amounts to EUR 2333 billion. EUR 560 billion of this sum account for assets denominated in EUR hold by residents in the euro area. If one, in a textbook-style manner, confines oneself on sales of assets except sovereign bonds as a method of sterilization, one could derive an upper bound for sterilization – in relation to the necessary debt rolling and new debt of euro area countries.

Another argument has to do with the consequences of too many toxic bonds on the ECB's balance sheets. If they lose value, the central bank has to be backed up by the government. The arguments against an explicit fiscal "back-up" of the ECB was already outlined in detail in a note prepared for the European Parliament for the March 2010 Monetary Dialogue, Chapter 5.<sup>10</sup>

Seen on the whole, thus, the considerations enacted in sections 2.1 to 2.6 above joint with the main results of my recent briefing paper (Belke, 2011) under the heading "Not too much leeway to act independently – The ECB and its political constraints" legitimize us to speak of a couple of quite inconsistent constraints in between which markets are still caught. Hence, a natural follow-up is to investigate potential scenarios of a euro area breakup which hopefully can be avoided in the end.

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<sup>9</sup> For details see Belke (2010), chapters 4 and 5, and Belke (2009), chapters 2.2 and 2.5.

<sup>10</sup>

<http://www.europarl.europa.eu/document/activities/cont/201003/20100317ATT70819/20100317ATT70819EN.pdf>

### 3. CONCLUSIONS

It cannot be excluded a priori that the economic costs of a doomsday scenario – a breakup of the euro area – would be high and extremely damaging, especially in the case of a weak country's departure. It seems at first glance as if the costs of breakup would be lower if a strong country were to secede.<sup>11</sup> However, in this case, the euro area would lose its pillar of stability, and the probability of a collapse of the whole EMU project would be even greater.

From a hysteresis point of view, euro area Member States appear stuck in their common currency area. However, any determined country could leave the euro and reestablish its own currency if a "pain threshold" is reached after having passed through a long period of imposed austerity and high unemployment inside the common currency area. But in this case, high costs would remain to be borne, and a banking crisis and social unrest would almost certainly follow in the wake of an enforced currency conversion. This is also valid for the departure of stronger countries. Germany might have several well-founded reasons for leaving the euro area, among them some of the most valuable principles of "Ordnungspolitik." However, the achievement of greater monetary and fiscal stability should not be included in this list, as a German exit would create domestic financial disarray for quite a long time (The Economist, 2010).

Indeed, once a country has voluntarily given up its national currency and monetary policy autonomy to a common currency area and its institutions, the costs of exiting from this monetary union and introducing a new national currency are more than significant. Moreover, the entry costs can be considered to be sunk ex post, and there will thus be a hysteresis impact on the optimum currency area (OCA) threshold. The optimum degree of economic integration which once served as a trigger for a country to join the euro area is higher than the trigger that induces a Member State to leave the common currency area. In this sense, the current pressing situation in the euro area still calls for a "tolerance band."<sup>12</sup>

The switch from national currencies to the euro was smooth in large part because it was planned over years in great detail, and even more important, in a cooperative manner among European countries (Eichengreen, 2008; The Economist, 2010). This again indicates that exit from and entry into a common currency area have to be treated in an asymmetric fashion. The mere prospect of euro breakup could cause bank runs in weak economies.

The political costs of the doomsday scenario – a true breakup of the euro area – are too great to be quantified in financial terms, no matter whether a weak or a strong country that secedes. Nevertheless, the time may come in which only a little additional shock is sufficient to shift the whole EMU project to a new trajectory, forcing its collapse. This could be the case if a "pain threshold" is reached after a considerable period of strain and pain, creating a climate for conducive to breakup (hysteresis).

Finally, it cannot be stressed often enough that any collapse of the euro area and resulting EU fragmentation would do significant damage to the European Union's international position and influence.

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<sup>11</sup> This fits with our assessment in section 2 that it may be at least as likely that the Northern member states with sound fiscal policy and high competitiveness will exit (Voth, 2011).

<sup>12</sup> This is an analogy to the exchange rate "band of inaction" as derived by Belke and Goecke (2005, 2009) in a Krugman-type framework.

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**NOTES**



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

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