**DIRECTORATE GENERAL FOR INTERNAL POLICIES**

**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

# THE ECB, THE EFSF (AND THE ESM)

## 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 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.

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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?

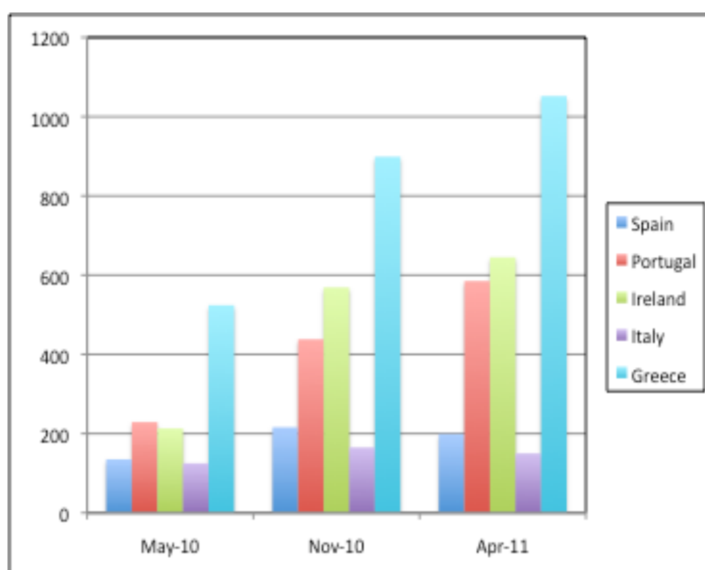
The sovereign debt crisis has created an unexpected situation, which has been met by unplanned policy actions. This includes the creation in May 2010 of the European Stability Financial Facility (EFSF), initially designed to last three years. When it became clear that the crisis would be bigger and would 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 loose 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 – contravene 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.[1]

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.

[1] 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 loose 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

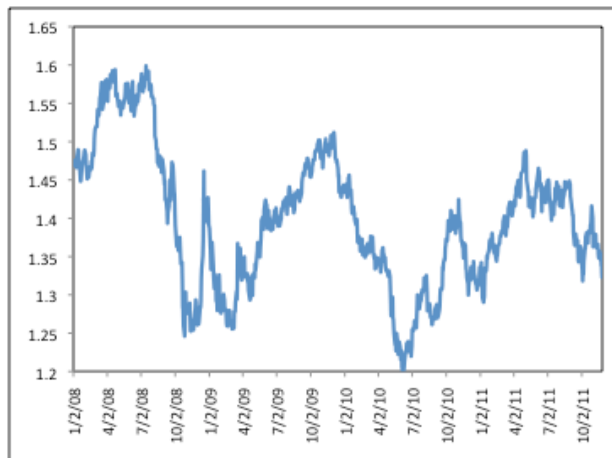
The EFSF can be seen as a budding European Monetary Fund. Do we need for such a new institution? The question is not simple. We already have the IMF, an institution with considerable experience (and where Europeans hold considerable influence, both formally and informally). The early statement by ECB 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 loose 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.[2] 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 EFSF 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.

[2] 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 word'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.[3] 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.

[3] 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.