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Liquidate or liquefy?

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> "…Liquidate labour, liquidate stocks, liquidate farmers, liquidate real estate… it will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people."

This was the advice of US Secretary of the Treasury Andrew Mellon to President Herbert Hoover in 1931. It is never advisable to mix economic policy with morals, as events have shown. One can question whether the advice was even taken since President Hoover actually implemented some expansionary policies. But it is clear that the wave of bank insolvencies and foreclosures that swept through the US during the early 1930s contributed to the transformation of a crisis into the Great Depression.

In Europe we have to ask ourselves today whether the opposite approach, i.e. no liquidation at all, is much better.

After the Lehman experience, the official policy line in Europe is that liquidation must now be avoided at all costs. This applies in particular to sovereigns and their banks.

How is this policy implemented? Most public attention has focused on the bail-out of countries via the EU/IMF package of €110 billion for Greece and later the creation of the so-called European Financial Stability Facility (EFSF). But given that banks and the government are so intertwined, it does not matter whether it is the sovereign that is over-indebted (Greece) and thus drags down its banks, or whether, on the contrary, it is the banking sector that is insolvent and drags down the sovereign (Ireland).

A much larger 'bail-out' has actually taken place via the balance sheet of the ECB. Here again public attention has focused on a minor aspect, namely the direct purchases of distressed government bonds by the ECB. However, the portfolio of government bonds held by the ECB under its 'securities markets programme' has so far amounted only to about €60 billion, a rather modest sum when measured against the overall balance sheet of the Bank, which now is close to €2,000 billion. Moreover, by buying bonds in the secondary market, the ECB has not provided any fresh money to the countries concerned. It has only increased the price at which some investors were able to sell their holdings of Greek and other bonds.

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The ECB, however, is providing direct support to the countries in trouble via its normal monetary policy operations, which allow the banking systems of these countries to refinance themselves at the official rate of 1% to the tune of hundreds of billions of euros. This represents an infusion of liquidity of an unprecedented magnitude given the small size of these economies. For example, the banking systems of Greece and Ireland have now received funding worth about 40% and 50% of GDP, respectively. See table below. It is clear that without this injection of essentially free liquidity, both countries would have been insolvent a long time ago.

Lending by central banks to credit institutions as of August 2010

	Total (€ billions)	**Lending by CB relative to deposits**	**Lending by CB relative to GDP**
Greece	96.1	26%	40%
Ireland	95.1	14%	60%
Portugal	50.1	15%	30%
Spain	119.0	5%	11%

Source: Own calculations from the websites of the national central banks.

This huge infusion of liquidity is of course just a by-product of the way the ECB's monetary policy works and not a tailor-made approach for countries in trouble (unlike the securities markets programme and the EFSF), but it implies a considerable subsidy. No Greek bank could have funded itself in the interbank market over the last year; even the government has had only limited access for short-term funds under the protection of the EU-sponsored bail-out.

Assuming that the risk premium for Greek banks would be equal to that of the Greek government (say for five years, i.e. outside the EU/IMF umbrella for the next three years), i.e. around 700-800 basis points, the lending of the ECB to the Greek banking system amounts to an implicit subsidy worth around 2.8 to 3.2% of GDP (7 to 8% of 40% of GDP). This is more than the country receives in structural funds from the EU. Even for Ireland, the implicit subsidy is worth about 2% of GDP, if one applies a risk premium of 400 basis points on the financing supplied by the ECB.

Insolvency can certainly be avoided as long as liquidity is (almost) free and available in unlimited amounts. Europe has clearly chosen 'liquefaction' over liquidation. However, unlimited 'liquefaction' has its disadvantages.

First of all, it is obviously not a solution for insolvent debtors; it just postpones the day of reckoning.

Secondly, it is addictive. Recourse to the ECB will remain by far the cheapest source of funds for banks in the euro periphery. They will thus try to increase their recourse to ECB funding all the time, with the result that the risk on the balance sheet of the ECB will be increasing. This is why the ECB had to recently tighten its eligibility criteria for the collateral it accepts, as banks in the periphery (and some weak banks in core euro states) had obviously a tendency to transform ever-more risky parts of their assets into securities that they could use as collateral for the ECB's windows. This illustrates a further problem: Political instances have to take over the function of capital markets. The ECB and the EFSF now decide which countries and banks have access to funding (and at what cost).[1]

[1] Representatives of the ECB have rightly pointed out that the capital market had made a fundamental mistake in funding Greece for too long at excessively low risk premia; and the market (and the ratings agencies) might now err in the opposite direction by overestimating the risk of insolvency. But who can guarantee that the ECB is right to lend 40% of GDP at a zero risk premium?

Is there an alternative between indiscriminate liquidation and continuing liquefaction? The obvious way out should be controlled rescheduling and/or restructuring in order to avoid turning part of euro periphery into 'zombie countries'.

The problem is that no debtor will ever appear insolvent (and admit to it) in an environment of essentially free money. No debtor will thus have an interest to engage in a restructuring or rescheduling as long as interest rates remain close to zero and liquidity is available without limits.[2] A 'Japanese' scenario in which financial markets cease to function properly is thus becoming ever more likely for Europe as well.

[2] Moreover, the ECB would have to admit a serious miscalculation if Greece were to restructure its (privately held) public debt. A restructuring of the official debt seems imminent as the maturity of the loans provided under the EU/IMF package of €110 billion is likely to be extended soon.