

Liquidity in times of crisis:

Even the ESM needs it

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Abstract

This paper argues that the new permanent European rescue fund, the European Stability Mechanism (ESM), should be provided with a liquidity backstop by having it registered as a bank – and be treated as such by the European Central Bank. If the crisis were to become acute again, the ESM would stand ready to intervene in secondary markets, potentially with almost unlimited amounts of funding. Access to central bank financing will be crucial in a future crisis, because in such a crisis risk aversion is likely to be extreme, and even the ESM might not be able to raise at very short notice the huge sums that might be required to prevent a breakdown of the financial system. Hundreds of billions of euro might be needed just to top up the programmes for Greece, Ireland and Portugal – and Spain and Italy may require more than a thousand billion euro. Sums of this order of magnitude cannot be raised quickly by a new institution. Simply increasing the headline size of the ESM might thus be of little use.

The 'ESM-bank' (effectively a European Monetary Fund) would be subject to the same rules that apply to all other banks and the ECB would accept only high-quality collateral from it. The ECB could abandon its programme of purchasing peripheral government bonds and it would retain the final say on whether to provide liquidity to the ESM. Thus, the ECB would remain in control of central bank money supply and its role would be restricted to the classic functions of ensuring price stability and acting as a lender of last resort for banks. The management of external and internal imbalances within the euro area would be left to the ESM under the supervision of the finance ministers.

Introduction: Sovereigns like banks

Canaries used to be kept in coal mines because they die faster than humans when exposed to dangerous gases. When the birds stopped singing, the miners knew that it was time to gear up the emergency procedures. Greece, as it turns out, was the eurozone's canary. In 2010, the canary was resuscitated, and a small rescue mechanism was set up which was activated a few more times to revive a further canary or two – but beyond this, the warnings were ignored. The miners kept on working. They were convinced that the canaries had overeaten and just needed to go on a diet to get well again.

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

The Maastricht Treaty explicitly ruled out any form of 'monetary financing' for governments. This was done to safeguard the independence of the ECB and thus ensure that governments would be forced to follow sound fiscal policies. While this prohibition of financing deficits via the printing press was needed in order to

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safeguard price stability, it can nevertheless create a problem when risk aversion becomes so great that even solvent borrowers can no longer roll over their debt. In such a situation, liquidity becomes a key factor, both for the sovereign and the banking system.

For the sovereign, the problem can be summarised as a maturity mis-match: a government has long-term assets (flow of tax revenues) and liabilities of a much shorter duration. A country with a balanced budget would normally be considered solvent even if the debt-to-GDP ratio is 100%, because with a balanced budget that ratio will decline towards zero as long as GDP grows in nominal terms. However, even if the average maturity of government debt is 8 years (rather conservative and almost the case for Italy), the same country has to refinance 12.5% of its GDP every year – a sum that far exceeds what even the strongest government could hope to finance out of a surplus. This implies that any government could immediately become insolvent if investors refuse to roll over the debt coming due. This is exactly the same mechanism as operates in a bank run. A bank typically has long-term assets (loans) but short-term liabilities (deposits). If all the depositors want their money back at the same time, the bank will not be able to liquidate its loan portfolio immediately (Diamond & Dybwig, 1983).

The danger of a run on government debt does not exist for a country with its own national currency (as long as government debt is in local currency) because then the national central bank can provide the liquidity needed to keep the sovereign solvent in the short run even in case of a total investors' strike. The potential for bank runs and their wide spread occurrence during the 1930s was the main reason why central banks became the lender of last resort for banks. Within the euro area, national governments, similarly to banks, need a liquidity back-up which can be provided only by the ECB. Any liquidity backstop mechanism – whether for banks or for sovereigns – requires by definition a distinction between insolvency and illiquidity.

For banks the final decision is usually taken by the fiscal authorities. We argue (see Gros & Mayer, 2011) that one should follow the same approach also for euro area sovereigns.

Moreover, even a 'supra sovereign' institution like the ESM could be subject to liquidity problems. After all the ESM has only rather long-term assets, namely the taxing power of the member states which have subscribed to its capital (and thus given the promise to pay a certain share of the liabilities of the ESM).

It is thus entirely possible that one day even the ESM will not be able to place all the bonds it would like to issue. The ESM is likely to need to go to financial markets when risk aversion is high because that is when peripheral euro area countries are likely to experience difficulties themselves. During these times the market might also become more sceptical of the political commitment of the remaining core countries to support their partners and might not absorb the hundreds of billions of euro that might be needed quickly. This is the fundamental problem which remains unresolved so far.

Summer of 2011: Anatomy of a crisis

The problem created by the absence of a lender of last resort for the sovereign became particularly acute after the European Council of 21 July 2011 – which was supposed to end the crisis by settling the Greek case with a mixture of generous long-term financing at low interest rates and some private-sector rescheduling and restructuring. The result of this summit was the opposite, however, as the crisis entered an even more acute phase with investors anticipating the quick unravelling of the July 2011 'solution' (an anticipation that proved to be correct).

The first-ever official announcement of a 'voluntary' haircut on private investors in government bonds of an EU member country did not escape the markets' notice, and they re-evaluated all their holdings of all peripheral government debt. The European Council officially assured investors in July 2011 that Greece was an "exceptional and unique case" – an assurance that has been repeated several times since. However, investors were not fully convinced then (and remain skeptical today) because at least one other country (Portugal) is facing a fundamentally similar problem to that of Greece, at least in terms of over-consumption and foreign debt.¹ Moreover, the size of the

¹ See Gros (2010).

haircut initially proposed (21%) was clearly unrealistic from the outset, and indeed it was increased to approximately 80% when Greece effectively defaulted in March 2012. To use an analogy: Investors who had so far believed that all swans are white had been shown a black swan. They cannot now be expected to forget that black swans exist.

Regardless of what had been promised, the official announcement that private investors would be required to take losses on their holdings of Greek government bonds opened a sort of Pandora's box, because this meant that other countries with high debt levels might end up in a similar situation. This created the potential for vicious feed-back loops. The argument is quite simple: even a rather high level of public debt would be sustainable if the government had to pay only a low interest rate, say, close to the compensation required on a riskless investment. However, the same level of debt might become unsustainable, forcing a country into default, if the borrowing cost is much higher. Hence many authors (most persuasively, de Grauwe, 2011) have argued that there might be multiple equilibria: if the market thinks the government can pay, it will be able to pay because its borrowing cost will be low. However, if the market thinks the government cannot pay, in practice it will not be able to pay because the high-risk premium requested will make the debt service so expensive that it will not be able to find the necessary resources. Doubts about the ability of a government to service its debt could thus become self-fulfilling.

This mechanism is similar to the maturity mismatch described earlier. But it works more slowly and becomes less likely the longer the maturity of government debt. The fact that high interest rates become a self-fulfilling prophecy of the ability of a country to service its debt offers a justification to provide fundamentally sound countries (those that are solvent at a reasonable risk premium) with financing at lower-than-market rates.

But the question that then arose in 2011 was simply whether there was enough money to cover everyone in the established crisis management mechanism.

Although the Greek public might not appreciate it, it has received preferential treatment from the EU. Greece now has essentially all its financing needs arranged, and is assured of paying less than 4% on the new debt it is incurring. Moreover, given that the country has little private debt left, it is clear that even the public creditors will in all likelihood have to agree to a de facto haircut as well once the new programme goes off track.

The two other countries with a programme, Ireland and Portugal, of course had to be treated 'equitably'. They have also been given more lenient terms (low interest rates and longer maturity) and the implicit assurance of further financing should they not be able to face the test of the markets in a few years.

But while Greece, Ireland, and Portugal obtained more generous official long-term financing, Spain and Italy experienced a surge in their borrowing costs in the summer of 2011. At that point, the debt fears started to affect even the core, with peaks in the spreads for France and even the Netherlands. The reason for this contagion is quite simple: there is not enough highly rated fiscal power in the eurozone. Countries like Italy and Spain cannot be expected to provide billions of euro in credits to Greece (and Portugal and Ireland) at low rates (approximately 3.5%) when they themselves are paying much more. Europe's leaders wanted to be generous to Greece, but the supply of cheap funds is limited. Not everybody can be served this way.

The EFSF and the ESM can only deal with a peripheral crisis

The eurozone's permanent rescue fund, the ESM, which will complement the European Financial Stability Fund (EFSF) in mid-2012, cannot provide all countries with financing on the scale required so far by Greece, Ireland and Portugal. It simply does not, and will not, have enough funds to undertake the massive bond purchases potentially required to stabilise markets. Even with a financing volume of €700 billion (as presently contemplated), it can provide emergency financial support only to small peripheral countries such as Greece, Ireland and Portugal.

The existing programmes for these three countries (the GIP) amount to close to about €400 billion, of which Greece alone needed almost €200 billion. The economies of Spain and Italy are more than ten times larger than that of Greece. This implies, as a rough rule of thumb, that about ten times 200 or about €2,000 billion might be needed in addition to the present commitments under a worst-case scenario. It is thus clear that increasing the rescue funds available by a few hundreds of billions of euro is not sufficient to deal with Spain and Italy.²

Moreover any financing that relies on guarantees and other contributions from member states separately is vulnerable to a domino effect. The headline numbers on the size of the ESM are thus misleading. Countries facing high borrowing costs cannot effectively be relied upon to provide contributions to the rescue fund (whether the EFSF or the ESM). This does not matter that much as long as only small countries are in trouble. But if (when) the borrowing costs of large countries like Italy and Spain (which account together for about one-third of the eurozone) soar, only the core eurozone members would remain to back the EFSF. At this point, the debt burden on the core countries would become unbearable and even their own borrowing costs might increase.

About 45% of the backing of the ESM comes from 'true' AAA countries (Germany, the Netherlands, etc.), another 35% from the periphery (Italy, Spain, the GIP) and a final 20% from France. During a full-blown crisis engulfing Italy and Spain, only about 65% of the headline lending capacity might actually be available in the sense that the market would in such a case absorb, at most, bonds issues equal to the guarantees (called 'callable capital' in the ESM framework) of the 'core'. Should even France no longer be considered sufficiently creditworthy, the effective lending capacity of the ESM would be reduced to only a little over one half (45%) of its headline figure. Even increasing the headline funding of the ESM to €1,000 billion, as proposed recently by the OECD, would not be enough to deal with a full-blown crisis.

² See also Green (2012) for similar calculations.

Events in 2011 showed this clearly. Even France experienced market pressure as doubts arose over its ability to deal with three contingent liabilities from the rescue of others on top of its already large existing stock of debt. At the peak of the crisis, even the EFSF had difficulties placing its bonds, and the yields on its bonds were for some time equal to those of France. The EFSF had thus to pay a considerable premium over the benchmark German paper. This is not surprising given that the EFSF was a new, untested legal construction, unknown to most investors outside Europe. The ESM will have a stronger legal framework and will be classified as an international institution. But the existing stock of this class of borrowers at present amounts to a couple hundred billions of dollars. If the ESM had to raise €700 billion from the market, it would have to convince investors worldwide to double or triple their allocation to this investment class. This would be a challenge in normal times and might well turn out to be impossible when the ESM actually needs the funding, which is likely to be in an atmosphere of extreme risk aversion.

This implies that a larger rescue fund is not the solution; if anything, it could accelerate the speed at which the dominos fall.³ The widely held view – that the firepower of the EFSF/ESM should be increased – does not make sense.⁴

In the summer of 2011, the domino effect started to operate because financial markets do not wait for country after country to be downgraded. They tend to anticipate the endgame, or at least one potential scenario, namely the unravelling of the entire EFSF/ESM structure. Markets were caught between three seemingly inconsistent constraints: 1) little chance for a sizeable increase of the borrowing capacity of the EFSF, 2) little

³ See Giovannini & Gros (2011) for a calculation of the size of the EFSF/ESM needed to deal with Spain and Italy.

⁴ This should be the case in particular for the country whose government has been most active in pushing for an increase in the funding for the ESM. Financial markets understood this risk and drove up borrowing costs for France – the core country that eventually lost its full AAA rating. If this process had continued, only Germany (and some of its smaller neighbours) would have been left to carry the whole burden. This would have been not only politically unacceptable but also economically impossible – the Italian government debt alone is equivalent to Germany's entire GDP.

chance for the introduction of Eurobonds and 3) great reluctance on the part of the ECB to engage in large-scale purchases of bonds of financially troubled governments.

In the end, the ECB ended up buying large amounts of Spanish and Italian debt in the course of the summer of 2011 and it subsequently injected a generous dose of liquidity into the banking sector, but it was clear from the outset that the ECB would never provide funds on the scale required to permit all investors to exit from southern European government bond markets.

The bank-government-debt snare

The crisis of 2011 also illustrated once more that one cannot consider the issue of financing sovereigns in isolation from the state of financial markets in general. Banks in particular are linked to the sovereign and sometimes they represent the weakest link. There are two reasons for this:

- i) Many banks hold large amounts of government debt
- ii) The credit rating of banks usually falls along with that of their own sovereign.

Bank holdings of government bonds create a problem when they are large. In all the peripheral countries, banks hold government bonds of their own government amounting to over 100% of their capital. This implies that any fall in the market value of government bonds will have a material impact on the value of the capital of the banks themselves.

Moreover, the ratings agencies almost never give a bank a higher rating than its own government. The reason is simple: in any financial crisis only the government can save a bank. These two facts imply that anyone expecting a country's downgrade would not be selling only government securities but also shares of its banks. This, in turn, increases the cost of capital for the banks, making them even weaker. Moreover, even stronger banks – which see their own share prices falling and credit-default spreads widening – react by refusing to provide the other banks with interbank liquidity. The breakdown in the interbank market, in turn, leads to a breakdown of the credit circuit, which kills growth.

This was the dynamic that led to the severe recession experienced after the Lehman bankruptcy. During the worst crisis moments of 2011, capital markets were anticipating the potential for a doomsday scenario with the economy going abruptly into a severe recession as the interbank market was breaking down and the public debt problems were growing further. These expectations might have well materialised had the ECB not addressed the issue in December of 2011 with the announcement of its new facility providing very long-term funding (3 years) coupled with easier collateral rules. The breakdown of the interbank market was averted, but the massive liquidity injection by the ECB also lowered pressure on governments and banks to clean up their balance sheets. Obviously, a central bank is unable to effectively link area wide bridge financing with adjustment pressure for individual countries, a task for which the founders of the Bretton-Woods monetary system therefore built the International Monetary Fund.

What needs to be done?

The EMS (or EMF,⁵ as we prefer to call this institution) has really two different tasks, which should be clearly separated by creating two departments, one dealing with programmes and one dealing with financial market stability.

The first department would manage and fund existing adjustment programmes – and future ones, should the need arise. Experience has shown that sometimes a country cannot get back to the markets without debt reduction. In this case, the EMF needs to facilitate orderly debt restructuring preferably along the lines of the Brady Plan. Adjustment funding and help for debt restructuring involves considerable risk and thus need be fully backed by fiscal resources from member states.

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

⁵ See Gros & Mayer (2010).

the event of a big liquidity crunch, the EMF might need very large sums at very short notice. This can be achieved only if it has access to ECB facilities by borrowing against the government bonds it is purchasing on the secondary market as collateral.

Assuming that the ECB insists on top quality in the assets it takes for collateral – assured, for instance, by a high rating – this would ensure that the EMF 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 21 July 2011 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.

If the ESM were to be registered as a (special) bank or ‘Monetary Financial Institution’ in Luxembourg, it would then have access to ECB funding under the same conditions as ‘normal’ banks, for which the central bank acts as a lender of last resort. This implies that even if risk aversion returns and the government debt of peripheral countries sells off again, the ESM would be able to act quickly and decisively without being limited by its ability to sell quickly hundreds of billions euro worth of bonds. The ECB would have the final say on whether or not it lends to the EMF, ensuring that it remains in control of the central bank money supply.

This does not imply that support from the ECB should be used to finance the ongoing adjustment programmes in the GIP country group. Adjustment funding and help for debt restructuring would be carried out by the EMF with the financial endowment already decided, which should be sufficient for these purposes. Smaller secondary-market intervention in case of limited liquidity gaps could also be funded in the same way. Liquidity support from the ECB would be needed only as a last resort in case of a big liquidity crunch. But if the liquidity support is potentially available, no liquidity crunch is likely to materialise much in the way that

deposit insurance has limited the likelihood of bank runs.

Deposit insurance goes hand in hand with banking supervision. Any support for the government bond market of euro area members must also be accompanied by policy conditionality. But who should impose this conditionality?

This should be the EMF, which would also be the proper institution to formulate and monitor the conditionality (obviously in conjunction with the European Commission and the IMF if necessary) which would have to go hand in hand with any support for member countries in difficulty, including buying bonds on the secondary markets. This was done implicitly by the ECB in the summer of 2011 when it used the threat of stopping its SMP (Securities Market Programme) in order to pressure the Italian government into undertaking reforms and fiscal adjustment. More recently, the very large liquidity injections via the longer-term refinancing operations (or LTRO) had no implicit conditionality attached. The LTRO was probably justified when it was launched, but it shows that a central bank has little choice when a crisis breaks but to venture into grey territory in which fiscal and monetary policy overlap (see also Weidmann, 2012).

There is no representation of the European taxpayer on the Governing Council of the ECB. This might lead to a tendency to be too much concerned about instability in financial markets and have too little regard for the interest of taxpayers (especially when the financial burden falls only on a few countries).

Secondary market interventions by the EMF seem to be preferable over a system-wide injection of liquidity if the problem originates in the government debt market. Secondary market purchases below par have the advantage that they automatically provide for some ‘private sector involvement’ or PSI. If, during a panic, the EMF buys longer-term bonds at 70 to 80% of face value, some private sector participants will suffer some losses. The EMF should of course engage in these purchases only if it deems the country as fundamentally solvent.

There is no danger to price stability from an ‘ESM-bank’ as the ECB would still be able to control liquidity developments for the entire

euro area. Once financial markets have returned to normal it could simply stop its policy of full allotment. At this point any refinancing of the EMF would simply crowd out financing to other banks and thus not increase area-wide liquidity. With full allotment the ECB cannot control the aggregate amount of liquidity in the system, independently on whether or not the EMS has access to the ECB lending facilities as any normal bank.

Backstopping the EFSF/EMS via the ECB – i.e. creating an EMF – would have the advantage that it leaves the management of public debt and external adjustment problems in the hand of the experts and finance ministries, but it provides them with the liquidity backstop that is needed when there is a generalised breakdown of confidence and liquidity.

In short: during a confidence crisis the fundamental problem of banks and governments is always one of liquidity. This is exactly when a lender of last resort is most needed. The ECB is the only institution that can provide the required ‘lending of last resort’ quickly and in a convincing quantity. But it needs the help of a fiscal institution, the EMF, to perform the role of lender of last resort without thwarting economic adjustment or jeopardising price stability.

What are the alternatives?

Some (e.g. de Grauwe (2012)) have argued that the ECB should simply resurrect its bond buying programme (called Securities Markets Programme or SMP). The problems with this approach are that the ECB should be responsible for euro area wide price and financial stability, not with the conduct of national fiscal policy and the enforcement of conditionality at the national level.

Another solution touted by some has been to establish joint and several liability for euro area countries’ debt. Many have argued that the financing problems of the periphery would disappear with the introduction of Eurobonds.

The danger here is that holding taxpayers fully and unconditionally liable for spending decisions taken in other countries would most likely turn into a poison pill for EMU. Political resistance against EMU would rise in the stronger countries, eventually probably leading

to a break-up of EMU. Moreover, if the issuance of Eurobonds were limited to a part of national debt (say only 40-60% of GDP as proposed), highly indebted countries would immediately be forced into debt restructuring as they could no longer find buyers for the part of their debt only guaranteed nationally. Moreover, this approach would require a change in the EU treaties and would probably not be compatible with the German Constitution.

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

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

Legal obstacles?

Is it legal? Opponents of our proposal argue that an ESM bank would contravene the Treaty, which prohibits ‘monetary financing’ of governments. As shown in more detail in the annex, however, this objection is not valid. In rediscounting government bonds bought on the secondary market, the ECB would treat the ESM only in the same way it treats all the banks, or ‘MFIs’, that perform the same operation.

Moreover, there exists a Council regulation that explicitly exempts two types of operations from the definition of ‘monetary financing’: balance-of-payments assistance to non-euro member states and contributions to the IMF. Logically one should apply the same principle to the ESM since it does not make sense to apply the prohibition of monetary financing in the case of financial assistance to euro area members, but not to non-euro area members. Moreover, all IMF operations are ultimately financed by central banks and a large part of the IMF loans to the GIP have in reality been financed by euro area central banks, and thus effectively by the

eurosystem. If this indirect financing of assistance to euro area countries via the IMF is legal, the financing of the same type of operation via the EMF should also be legal.

Conclusions: No silver bullet

Bringing EMU back to safe ground will of course only succeed if first deficits are reduced substantially and then debt levels (as a % of GDP) are brought down slowly as well. The financial crisis has vividly demonstrated that excessive debt loads, especially if combined with large deficits, cannot be financed in anything but the extremely benign markets that prevailed between 2000 and 2007. Countries that accumulate excessive debt will sooner or later experience their 'Minsky moment', when the rolling over of this debt becomes impossible. For a stable EMU, a long-term movement towards lower debt levels is a *conditio sine qua non*. The mechanisms to achieve this pre-condition have now been considerably strengthened through the tightening of the rules of the Stability Pact, the reverse qualified voting mechanism (under which a proposal by the Commission to sanction a country in excessive deficit is taken to be approved unless it is overruled by a qualified majority), and the so-called 'Fiscal Compact' which calls for member countries to adopt balanced budget rules at the national level.

However, debt reduction takes a very long time, hence the need for an effective crisis-management mechanism along the lines sketched above. In the absence of a mechanism with which to forestall a liquidity crisis, the other mechanisms will not be able to work, and EMU will fail.

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

Safeguarding financial stability during a crisis might require large secondary market interventions. The responsibility for this decision should be taken by the finance ministers represented in the ESM who can put their taxpayers' money on the line. But a liquidity backstop is needed to ensure that the ESM is able to perform this function even under extreme market conditions.

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Annex: Legal Issues

It has been argued that our proposal is not compatible with the prohibition of monetary financing of public bodies. The discussion has become somewhat ideological with opponents alleging that given the EMS access to ECB financing would open the floodgates for unlimited financing and thus inflation.

However, this is not the case. The financial stability department of the EMF would essentially perform the same function as many private sector investment funds located (in Luxembourg and elsewhere), which are recognised as 'Monetary 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 prices are low (yields are high)). This sub-vehicle would of course have to satisfy the the general eligibility criteria the Eurosystem uses for counterparties (i.e. minimum reserves, financial strength, operational criteria in contractual or regulatory arrangements with the ECB). But this should be a problem. Moreover, the EMF would not extend credit to governments, it would only perform a function that has until been undertaken by the eurosystem itself through the SMP. There is thus no material reason why this activity should fall under the prohibition of the ECB to finance governments (Art. 123, 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 ESM/EMF rather than on who ultimately benefits from the funding the ECB provides to the EMF. One side effect of the LTRO was that indeed banks could buy (or at least hold on to) government debt which had temporarily fallen in value.

The key issue would then be whether the EMF falls under any of the categories listed in Article 123, paragraph 1. Nowhere in Article 123(1) is there a reference to indirect funding, or the purpose for which access to ECB funding is to be made; there is simply a prohibition on certain classes of entity from receiving ECB monetary financing.⁶

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 (an EU body, but with a distinct legal personality, registered in Luxembourg, like the EFSF and owned by member states and the Commission) from obtaining refinancing from the ECB. In 2009 the EIB was recognised as an "eligible counterparty" by the ECB with access to ECB refinancing "as any other counterparty". As the ECB itself explains in a press release of 7 May 2009, this was "a natural complement to the EIB's financing initiatives". The reason is that paragraph 2 of the article 123 TFEU provides an exemption:

Article 123(2) reads:

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

This means that the EMF (or perhaps only its financial stability arm) could benefit from the exception in Article 123 paragraph 2, if it could

⁶ Those arguing against our proposal are coming from the perspective of what the ECB funding to the EFSF will be used for, i.e. indirect government financing, but neither Article 123 nor Council Regulation (EC) 3603/93 mentions indirect financing – Article 123 only refers to direct financing.

be considered a publicly-owned 'credit institution'. Given that, as mentioned above, a number of investment funds are recognised as credit institutions there is no substantial reason why this should not be possible.

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

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

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, which says:**

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.

This Council regulation thus exempts both the financing of the IMF and the financial assistance to non-euro-area membership from the scope of Article 123.

Given that financial assistance to euro area member states will soon also have a treaty base (via the addition to Article 136, which has already been agreed politically) there does not seem to exist any legal obstacle to treat

differently the assistance to euro area member states. A change in this Council Regulation could be agreed quickly by the heads of state.

From a substantive point of view it is difficult to understand why the prohibition of monetary financing should be applied to financial assistance to euro area members, but not to non-euro area members. Moreover, those who oppose our proposal usually support a greater involvement of the IMF in euro area rescue operations. However, all IMF operations are ultimately financed by central banks and a large part of the IMF loans to the GIP have in reality been financed by euro area central banks, and thus effectively by the eurosystem.



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