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Global Economics View

Sovereign Liquidity Facility, Transfer Europe or Bank Recapitalisation Fund?

- €860 bn has been assembled by EA and EU governments and by IMF to support EA sovereigns.
- 3 possible uses for these funds:
 - (1) Sovereign liquidity facility;
 - (2) Sovereign bail-out fund/transfer Europe;
 - (3) EA bank recapitalisation fund/EA TARP.
- We expect a combination of a sovereign liquidity facility and a bank recapitalisation fund, with the temporary taint of a sovereign bail-out fund.
- ECB seems an increasingly dominant player in quasi-fiscal rescues of EA sovereigns and banks.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Sovereign Liquidity Facility, Transfer Europe or Bank Recapitalisation Fund?

What is the EFSF meant to be?

Introduction

The EU/IMF Facility now holds €860bn

Since May 3, 2010, the European Union (EU) has, with a little help from the IMF, put together an €860bn war chest to deal with sovereign debt issues in the Euro Area (EA). This pot of money, which will be made available as loans or credit lines, has several components. A dedicated facility for Greece contains €110bn, of which €80bn comes from the EA member states and €30bn from the IMF. The EA funds are provided on an intergovernmental basis, with the debt issued to fund the loans guaranteed pro rata by the 16 participating EA member states, in proportion to their relative share capital in the European Central Bank (ECB). Of the remaining €750bn, €60bn comes from a supranational EU facility (effectively jointly and severally guaranteed by the 27 EU member states). A further €440bn is made available through an intergovernmental EA arrangement.

Like the EA money for Greece, this €440bn facility, provided through a special purpose vehicle (SPV), now established as a limited liability company in Luxembourg, is guaranteed pro rata by the 16 EA member states. This entity is now known as the European Financial Stability Facility or EFSF. The weighted average of EA member states' credit rating (excluding Greece) is AA+ or thereabouts. To secure a triple-A credit rating for the EFSF, each of the participating countries guarantees debt worth 120% of its share. In addition, a cash reserve will be established as soon as the Facility is first activated, probably on July 1, 2010. This presumably implies a measure of pre-funding of the Facility. It is not clear whether the funds provided to set up the cash reserve are additional to or part of the 120% over-guarantee. Finally, the IMF is believed to be ready to come up with €250bn (on a one-country-at-a-time, one-program-at-a-time and one-IMF-Executive-Board-approval-at-a-time basis).

Three possible uses of the Facility:

- **A sovereign liquidity fund**
- **A sovereign bail-out fund**
- **A bank recapitalisation fund**

A key question, unresolved as of now in our view, is what the exact purpose or purposes are for which these funds can be dispensed. We believe that there are three distinct potential purposes to which the €860bn (henceforth the EU/IMF Facility – lumping together the set of disjoint facilities described above) can be allocated. These reflect three different views on the nature of the Facility. The first is to view the Facility as a sovereign liquidity facility or a mutual fiscal insurance facility. The second is to view it as a sovereign bail-out facility, or a sovereign subsidy or transfer facility. The third views it as a bank recapitalisation facility.

We believe the Facility will be used as a convex combination of the first and third models, that is, as a combined sovereign liquidity facility and bank recapitalisation facility, with just a whiff of the second (bailout) model, because of the decision not to restructure the debt of the Greek sovereign prior to allowing the Greek government access to its part of the Facility.

The fuzzy boundaries between private and public during financial crises

Financial sector private in good times, public in bad times

There have been many reflections on the proposition that when things go well, the financial sector is private, but that when things go badly, it becomes public. The ongoing financial crisis in the US and Western Europe has offered many illustrations of the generic correctness of this proposition. A related

Large private financial crisis can trigger sovereign debt crisis

proposition is that a private debt crisis can, if it is sufficiently large, trigger a sovereign debt crisis. Certainly, the private debt crisis in industrialised countries that started in August 2007 entered its sovereign phase following the Greek parliamentary elections of October 4, 2009, show the validity of the second proposition.

Even earlier examples of private insolvency crises causing sovereign distress can perhaps be identified in the current crisis; for instance, when Iceland's government could not bail out its cross-border banks in October 2008 because they were too large to save and would have dragged the sovereign down into default if the sovereign had attempted a rescue.¹ Likewise, the decision by the Irish government on September 30, 2008 to guarantee most of the unsecured liabilities of the Irish banks can be viewed as another example of private financial excess almost triggering a sovereign default.² Statements by the then German Finance Minister Peer Steinbrück on February 16 and February 18, 2009, to the effect that Eurozone member states would have to act if one of their number were to be unable to service or refinance its debt – an implicit guarantee of a fiscal bail-out - calmed the markets.³

The most recent private sector financial crisis resulted, like financial crises before it, from excessive credit growth to the private sector. The result was excessive household sector leverage in a number of countries (including the US, the UK, Ireland, Spain, and Portugal), and excessive banking sector leverage throughout the advanced industrial world. There also were some spectacular asset booms and bubbles, especially in credit markets (from the ABS and CDO markets to the Euro Area sovereign debt markets) and in some (but not by no means all) real estate markets – especially the markets for residential real estate.

Private sector financial crisis and aftermath have weakened sovereigns throughout the industrial world

The financial collapse, and the global economic downturn that followed, have been major contributors to the sovereign debt crises that have engulfed Greece and are threatening a number of other Euro Area countries, notably Spain, Ireland, Portugal, Italy, Belgium and Austria. They have indeed contributed to a significant impairment of the fiscal position of all but a handful of advanced industrial countries - all except Sweden, Finland, Denmark, Norway, Australia and New Zealand.⁴ All the others – including the UK, France, Japan and the US - remain at risk of being subjected to painful financial market discipline or worse, should they fail to engage in major and sustained fiscal tightening. For virtually all advanced industrial countries other than the virtuous sextet mentioned above, early or even immediate fiscal tightening is indicated. Germany could well be the only exception – and it is set for imminent tightening anyway. For the UK and France, the time for drastic tightening is

¹ See Buiter and Sibert (2008).

² The guarantee was announced on September 30, 2008 by the minister of finance and became law on October 2, 2008. The guarantee is effective until September 29, 2010. The Irish authorities are currently seeking European Commission consent to extend the duration of the guarantees (except for subordinated debt) until the end of 2010.

³ On February 18, 2009, the Financial Times reported, in an article by Bertrand Benoit and Tony Barber, 'Germany ready to help eurozone members', the following: "Asked on Wednesday [February 18, 2009 WHB] whether Germany would risk seeing the eurozone break up rather than take action, Peer Steinbrück, finance minister, told a press conference: "Could you imagine anyone would be willing to put up with this? We would have to take action." Mr Steinbrück told an event in Düsseldorf on Monday night [February 16, 2009 WHB] that "the euro-region treaties don't foresee any help for insolvent countries, but in reality the other states would have to rescue those running into difficulty".

⁴ Switzerland is a member of the fiscally robust group only if one ignores the contingent exposure of the sovereign to its very large and highly leveraged cross-border banking system.

US not immune against bond market vigilantes despite buffer of US dollar global reserve currency status

surely now. For Japan, no later than next year. The US continues to benefit from the buffer against financial market discipline provided by the global reserve currency role of the US dollar and the associated safe-haven status of US government liabilities and other US securities.

Because the underlying fiscal situation of the US is worse than that of the Euro Area as a whole and no better than that of the UK, we expect that the shield against the bond market vigilantes provided by the reserve currency status of the US dollar will be pierced eventually by the cumulative effect of large and unsustainable government deficits. Absent significant early additional fiscal tightening, US Treasury debt is likely to lose its triple-A status within the next four years, as the US general government debt burden climbs towards and crosses 100 percent of annual GDP. Such an external trigger may well be all it takes to produce the sharp rise in long US bond yields that will finally prod the US Congress and the Executive into action. Early fiscal tightening in the US is highly unlikely, as the White House on January 19, 2010 announced the creation of a bipartisan commission or panel to make recommendations to the US Congress on ways to reduce the Federal budget deficit.⁵

Private financial sector excesses weakened sovereigns to the point that, in a future financial crisis, 'too big to fail' may become 'too big to save'

Private sector financial excess (enabled by across-the-board regulatory and supervisory failure and unduly lax monetary policy) was at the root of the financial crisis that started in August 2007. This helped bring on the global recession of late 2008 and 2009, which in turn was a major driver of the sovereign debt crises present, imminent or delayed, that are making today's headlines. It is therefore a rather bitter irony that the very weakness of the public finances caused, directly or indirectly, by this private sector financial excess, now threatens to abort a steady economic recovery let alone a vigorous one. The reason is that some sovereigns, especially in the EU, may be too stretched fiscally to be able to restore the banks in their jurisdictions to the balance sheet strength required for these banks to intermediate a strong recovery.

In most of the industrial world, the recovery is impaired, and in some cases delayed until further notice, by the weakening of the balance sheets of key financial intermediaries, especially commercial banks, investment banks and universal banks, that has resulted from the financial crisis and the global recession.

Many Euro Area banks non-transparent, suspected of hiding losses, over-leveraged and under-capitalised

In the US and in the UK, these weaknesses have been recognised and addressed to a greater degree than in the Euro Area. The initial damage done to the US and UK banks by the financial crisis may well have been larger than that done to their Euro Area counterparts. However, the US and UK banks are now generally viewed as stronger than most of their Euro Area counterparts because the former have been subjected to serious stress tests (with the results published for the individual American banks), because they have marked to market impaired and illiquid risky assets, and because they have engaged in large-scale recapitalisations, partly using public funds and partly with equity obtained from the markets. Euro Area banks and their regulators/supervisors have been much less forthcoming about marking to market bad assets and about recognising losses. Publishing individual bank

⁵ Appointing a commission is often seen as the time-honoured way of kicking a difficult, awkward problem into the tall grass rather than dealing with it as a matter of urgency. For the commission's recommendations to go to Congress for a vote, 14 of its 18 members would have to agree to them. And that is just to get it through the door of the Legislative branch of government. The commission had to be established by Presidential decree, after failing to gain the required majority in the Senate. It is scheduled to report by December 2010.

And that was before sovereign debt crisis hit Euro Area banks

level results of serious stress tests was, until very recently, anathema and much less new capital has been injected into the banks' balance sheets.

These Euro Area banking sector and regulatory/supervisory failures have created a material risk that the sovereign debt crisis now buffeting the region may cause another round of banking crises in the Euro Area, through the effect of low secondary market values of some Euro Area sovereign debt - especially that of the Peripherals (Greece, Spain, Ireland, Portugal and Italy), but before long possibly also that of other countries, including Belgium, Austria and France. Euro Area banks have (on average) highly concentrated exposures to the debt of the Peripherals, including their sovereign debt (see BIS (2010)). This, itself, represents another example of regulatory and supervisory failure – with Euro Area banks permitted or even encouraged by their regulators to hold large amounts of Euro Area sovereign debt, based on the mistaken assumptions that all Euro Area sovereign debt was more or less the same, and that all of it was safe.

Concentrated exposure to Peripheral sovereigns and countries makes many Euro Area banks fragile

Should the risk of an early restructuring-with-NPV-haircut of the Greek sovereign debt materialise, and should one or more of the other Peripherals end up requiring access to the funds provided by the €440bn EFSF and/or to other parts of the €750bn pot of money put together for EA member states other than Greece, a sharp mark-down (and, in the case of a restructuring, a partial write-off) on the value at which Euro Area banks carry these sovereign debt instruments in their balance sheets looks bound to result. This could weaken the capital positions of many Euro Area banks materially.

With many of these weakened banks unable to attract additional capital from the markets, the only source of capital would be their sovereigns, other sovereigns or the ECB. These 'other' sovereign capital contributions could come from a range of sources. One would be Sovereign Wealth Funds (SWFs) and similar public sector asset managers from outside the EU. We expect that, although acquisitions of equity stakes by SWFs from emerging markets (and from Norway) may well occur, political sensitivities will limit their size and scope. Another source would be the EFSF and the other pots of money collectively labeled the EU/IMF Facility in the previous section. The IMF's contribution to this Facility could not easily be directed into bank recapitalisation, as the Articles of Agreement of the IMF only permit it to supply short-term balance of payments financing, not long-term recapitalisation support and certainly no permanent transfers, current or capital, of any kind.

The three models for the Facility in greater detail

As stated in the previous section, we see three alternative models for the use of the €860bn EU/IMF Facility

1. A liquidity facility or mutual fiscal insurance facility for illiquid but solvent EA sovereigns.
2. A transfer/subsidy facility from fiscally strong to fiscally weak (insolvent) EA sovereigns.
3. A recapitalisation fund for under-capitalised/insolvent EA banks.

The German or liquidity facility model

The first model, the liquidity model, can be called the German model. In this model the loans provided by the Facility are priced in such a way that there is

no ex-ante subsidy to the recipients; that is, the cost of the loans equals the risk-adjusted cost of funds to the donors. This can, of course, in disorderly and dysfunctional financial markets, be below the cost at which the beneficiaries/borrowers would be able to borrow in the markets. As an alternative to loans and credit lines, the Facility could take a leaf from the ECB handbook and purchase the sovereign debt of the illiquid government outright. For it to be credible that the loans provided (or the sovereign debt purchased) by the Facility will not turn into open-ended and possibly uncapped transfers or subsidies from the fiscally strong to the fiscally weak, tough and credible conditionality has to be attached to access to the resources of the facility.

Credible sovereign liquidity fund requires teeth:

SDRM

To be credible as a liquidity facility, the EU/IMF Facility should (at least) have the following features

1. A sovereign debt restructuring mechanism (SDRM). This may be necessary ex-ante, if a patently insolvent sovereign wishes to access the Facility. To ensure that any loans made to the sovereign are indeed not ex-ante subsidies or grants, that sovereign's debt should be restructured in an orderly manner, including a net present discounted value (NPV) haircut for the creditors and a possible smoothing of amortisation payments through maturity lengthening. It may also be necessary ex-post (that is after a loan has been provided to a sovereign) if the sovereign, despite appearing to be solvent ex-ante, turns out to be unable or unwilling to comply with the conditionality imposed as part of the loan package.
2. The denial of further loans and the calling (mandatory early repayment) of the outstanding loans made to any sovereign deemed to be in wilful non-compliance with the conditionality attached to the loans. This would in all likelihood push the affected sovereign into default. Such a default should be managed in an orderly fashion. Hence the need for the SDRM.
3. The ineligibility as collateral at the Eurosystem of debt issued by sovereigns deemed to be in wilful non-compliance with the conditionality attached to the loans. This would have the further advantage of taking the rating agencies out of the sovereign collateral eligibility decision by the ECB.

Non-compliance with conditionality means denial of new loans and calling of past loans

Non-compliance means sovereign debt ineligible as collateral at Eurosystem

The combination of (1), (2) and (3) should be enough to ensure that the loans from the Facility do not turn into grants or subsidies. Additional sanctions could, however, be imposed, without requiring a revision of the EU Treaty. These include the denial of EU Structural and Cohesion funds to non-compliant borrowers from the Facility. Imposing fines, as per the Stability and Growth Pact, would not be effective, in our view: collecting money from transgressors when they are short is a lot harder than denying them money. Other, in principle, attractive non-financial sanctions would in all likelihood require Treaty amendments. They include the suspension of voting rights of wilfully non-compliant countries in Ecofin, the Eurogroup and the Governing Council of the ECB, and the expulsion of the country from the Euro Area, without this necessarily implying its expulsion from the EU.

Facility too small: needs €2 trillion

Even as a pure liquidity facility, the €860bn EU/IMF Facility is likely to be too small. Although the Facility could fund all of the roll-over and anticipated future deficit financing requirements of Greece, Spain, Ireland and Portugal for the next 3 years, it would last less than 2 years if Italy were to join the club of borrowers (see Buiter (2010)). A Facility of, say, at least €2 trillion would meet the sovereign funding needs of any conceivable combination of Euro Area

member states (i.e. member states other than Germany, the Netherlands, Finland and Luxembourg) for almost 3 years. This would allow intervention with the “overwhelming force” recommended by General Colin Powell or the threatened firing of the big bazooka favoured by former Treasury Secretary Hank Paulson. Clearly, because the sovereign debt problems addressed by the EU/IMF Facility are perennials, the Facility should not have just the three-year life (with up to five-year loans) bestowed on it currently. We think it ought to be made permanent.

The French or ‘Transfer Europe’ model

‘Transfer Europe’ could mean exit of Germany from Euro Area and EU

The French model represents the creation of a supranational fiscal entity in the EU/EA, with independent tax and borrowing powers. In this model, there is no presumption that a loan (bearing an interest rate that reflects the lenders’ risk-adjusted opportunity cost of funds) provided to a sovereign who is incapable of funding himself in the market, will be repaid in full. Discipline on the recipient would be enforced through the de-facto (partial) loss of fiscal sovereignty by the recipient, and possibly through the loss of other aspects of national sovereignty in the economic domain as well. Until a sustainable fiscal position is restored (with the aid of fiscal transfers/subsidies from the other EU/EA member states), the beneficiary of the transfers/subsidies would not be free to set his own public expenditure, taxation and wider structural reform priorities.

The bank recapitalisation model

This could be implemented in a number of ways. One would be for the Facility to fund a Euro Area-wide ‘bad bank’ that would buy ‘bad’ assets of EA banks, with the Facility, in addition, injecting its triple-A rated debt into the banks’ balance sheets or acquiring equity stakes directly in the banks. Alternatively, the Facility could demand that some of the loans provided to a sovereign be used to acquire equity stakes in one or more of that country’s banks.

Because of the sovereign debt crisis, we believe Euro Area banks need a lot more capital than is publicly recognised by IMF and EU authorities

In its April 2010 Global Financial Stability Report (IMF (2010)), the IMF states that “*Since the October 2009 GFSR, total estimated bank writedowns and loan provisions between 2007 and 2010 have fallen from \$2.8 trillion to \$2.3 trillion. Of this amount, around two-thirds (\$1.5 trillion) had been realized by the end of 2009.*” and “*For euro area banks, improvements in GDP growth and unemployment forecasts have brought down estimated total loan writedowns and provisions by \$38 billion to \$442 billion since the October 2009 GFSR.*”

These results are summarised in Figure 1 below:

Figure 1. Realised and Expected Writedowns or Loss Provisions for Banks by Region (billions of U.S. dollars, unless otherwise), April 2010

	Realised writedowns or loss provisions: 2007:Q2 - 2009:Q4	Expected additional writedowns or loss provisions: 2010:Q1 - 2010:Q4	Implied cumulative loss rate (percent)
US	680	205	7.0
UK	355	100	5.4
Euro Area	415	250	2.9
Other Mature Europe	82	74	3.9
Asia	23	92	1.5
Total for Loans & Securities	1,555	721	4.2

Source: IMF (2010) and Citi Investment Research and Analysis

Although we have no information with which to contest the IMF's assertion about the quality of the loan book of the banks in late 2009 and early 2010, it is important for one's view of the balance sheet strength of the EA banks to recognise that the IMF statements have nothing to say about the quality of the EA banks' portfolio of securities, including specifically their portfolio of sovereign debt instruments. We now believe that, since October 2009, there ought to have been a general recognition that (1) there may well be no completely safe sovereign debt anywhere, and that (2) there are material differences between the creditworthiness of different G7 member states' sovereigns and between different EA member states' sovereigns. There was more than €2.8 trillion worth of sovereign debt of the 5 Euro Area Peripherals outstanding by the end of 2009 (see Buiter (2010)). Reports from the BIS (2010) and from national regulatory sources suggest that EA banks have significant exposure to the sovereign debt of the Peripherals and even greater exposure to their private sectors, which are unlikely to prosper if the sovereign were to be severely challenged in the markets for its debt.

Euro Area banks therefore need additional capital – a lot of it. This may not be apparent from their ratios of regulatory capital to risk-weighted assets but, in our view, both the numerator and the denominator of this ratio are deeply unreliable. Many EA banks include in their definition of tier-one capital things other than tangible common equity – the only unconditional loss absorber, in our view. In addition, we think the risk weightings are deeply flawed (triple-A rated sovereign debt is assigned a zero risk weighting, for instance) and depend in part on non-verifiable model-based information provided by the banks themselves. Gross leverage ratios provide, in our view, a less distorted picture of the default risk of banks. It is true that, in principle, higher leverage can be achieved without increasing risk, simply by adding matching assets and liabilities to the balance sheet. In the real world, however, there is but one reason banks take on additional leverage: that is, to assume additional risk.

Past Euro Area stress tests uninformative

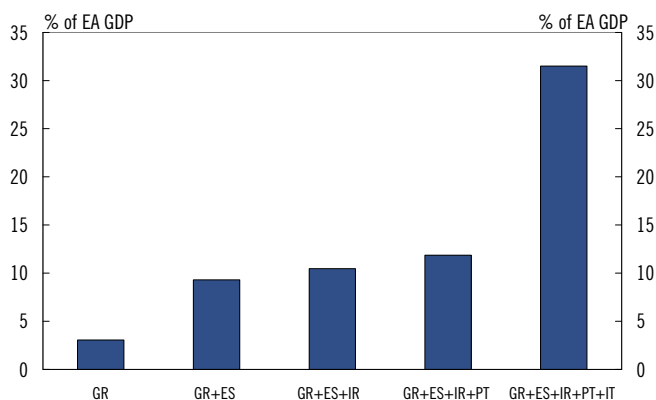
In addition to the excessive leverage of many EA banks, there is the long-standing problem of their apparent lack of transparency. Many of them continue to avoid, through a variety of accounting measures, allowed by changes in rules and conventions introduced since the start of the financial crisis by the International Accounting Standards Board (IASB), the marking to market of many illiquid and risky assets. The results of earlier stress tests conducted by their national supervisory authorities under the coordinating aegis of the Committee of European Banking Supervisors (CEBS) were not communicated to the markets in a satisfactory way, in our opinion. Neither the methodology nor the results for the individual banks were put in the public domain. Even the aggregate results for the 22 largest EU cross-border banking groups, published on October 1, 2009 by the CEBS (2009), were uninformative and suggested to us that the CEBS is easily stressed.

We believe new stress tests will only be useful if they consider multiple Euro Area sovereign defaults

The exercise is apparently being repeated as we write this, with the results, including the results for individual banks, to be published by the middle of July 2010. Although this represents a step forward, the stress tests are unlikely to include questions like: how would the solvency position of your bank be affected by a restructuring, with a 30 percent NPV haircut, of the sovereign debt of (1) Greece; (2) Greece and Spain; (3) Greece, Spain and Ireland; (4) Greece, Spain, Ireland and Portugal; and (4) Greece, Spain, Ireland, Portugal and Italy. In the absence of stress tests that include scenarios involving multiple sovereign defaults, we think it is difficult to view even the new exercise as a major confidence-boosting event. Added to this is the problem that the national implementation of these stress tests is left to the same national

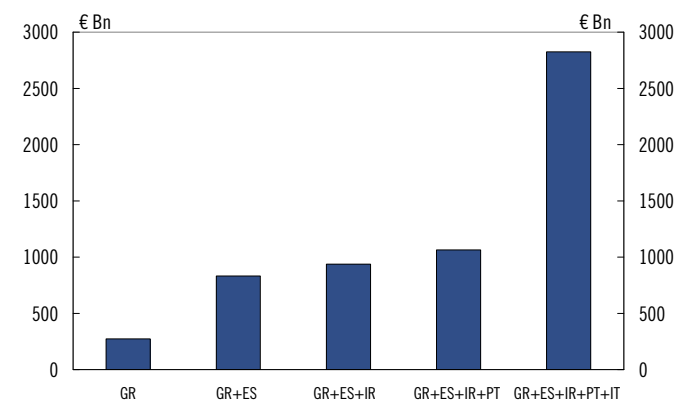
regulators and supervisors that failed in so many countries, including Germany, France, Spain, the Netherlands, Belgium and Ireland, to anticipate and prevent the excesses that undermined so many of the institutions they were responsible for regulating and supervising. It does not matter very much whether these regulatory and supervisory failures were the result of incompetence or (cognitive) regulatory capture (see Buiters (2009)). The results of stress tests performed by those who failed to prevent the last crisis are likely to convince few market participants.

Figure 2. 5 Peripheral Euro Area Countries – Public Debt (% of GDP), 2009



Sources: Eurostat and Citi Investment Research and Analysis

Figure 3. 5 Peripheral Euro Area Countries – Public Debt (EUR Bn), 2009



Sources: Eurostat and Citi Investment Research and Analysis

Which of the three models will it be?

Expect mixture of slightly tainted sovereign liquidity fund model and bank recapitalisation fund model

We believe that the outcome will be a convex combination of the German model (slightly tainted initially by the French model) and the bank recapitalisation model.

The ‘Transfer Europe’ or ‘supranational redistribution’ model will likely not be implemented because it would be unacceptable to Germany and a number of other EA countries with relative strong fiscal positions, including the Netherlands, Finland, Luxembourg and Slovakia. We believe that opposition in some of the fiscally strong countries in the EA to the EU/IMF Facility turning into an open-ended and possibly uncapped transfer or subsidy mechanism from the fiscally strong to the fiscally weak is so strong that the Euro Area and the EU could be destroyed by the defection of its fiscally strong members should it be adopted. In our view, fiscal federalism in the EU is simply not on the cards for the foreseeable future.

We think the chance of adopting the pure German model of a sovereign liquidity fund or mutual fiscal insurance facility ‘with teeth’ from the start was missed when Greece was granted access to the Facility without being required to restructure its sovereign debt first. We believe that a restructuring of Greece’s sovereign debt, involving both maturity lengthening and an NPV haircut that would put Greece’s post-restructuring public debt to GDP ratio at the EA average, is all but inevitable (see Buiters (2010)). Because the loans from the Facility are pari passu with the outstanding Greek sovereign debt (except for the IMF component which, according to IMF lore, enjoys preferred creditor status and is therefore senior), the governments guaranteeing the debt that funds the loans to Greece would, in the event of a sovereign default, take a haircut alongside Greece’s other creditors. This would be a major political issue

in countries like Germany, but need not be fatal to the Facility or to the EA and EU, as long as the manner in which Greece is dealt with, if and when its sovereign defaults, is sufficiently punitive to make it likely that both recidivism (by Greece) and emulation/imitation (by other fiscally challenged countries) is unlikely.

Future access by sovereigns to the Facility should therefore be open only to sovereigns that either appear, with a reasonable likelihood, to be solvent or that have had their debt restructured and reduced to a level that makes them likely to be solvent.

It is, however, quite probable that part of the funds in the Facility will end up being used to recapitalise banks in the EA. This is especially likely for weak banks located in countries with fiscally weak but potentially solvent sovereigns. When (if?) the stress tests reveal the true extent of the hole in the balance sheets of many EA banks, fiscally challenged and illiquid, albeit potentially solvent (given market access on reasonable terms), sovereigns may simply not be able to raise the funds they need to support their systemically important financial institutions. In that case, we see only two plausible sources of funds. The first is the EU/IMF Facility. The second is the ECB/Eurosystem.

ECB likely to be required to provide emergency funding in case of crisis, until Facility can take over

Since crises tend to strike faster than even the EU/IMF Facility can move – the Facility has to access markets and issue debt unless it pre-funds itself on a sufficient scale – the ECB may well be the future source of bridge financing of first resort. That, after all, was the position it found itself in on Monday, May 10, 2010, when it initiated outright purchases of Peripheral sovereign debt to forestall possible multiple unnecessary sovereign defaults resulting from self-fulfilling liquidity crises.

Both the ECB's transformation into a potential Gosbank and creation of Facility seem more motivated by fear of a banking crisis than fear of sovereign default per se

The ECB is, of course, very well set up to fulfil this role. Its cataclysmic change of heart over the weekend of May 8 and 9, 2010 not only saw the ECB recognise the need to purchase EA sovereign debt outright; possibly even more important was its decision to broaden its outright purchases of private securities beyond the covered bonds it had agreed to buy since July 2009.⁶ Alongside the other banking sector supporting measures announced at that same time – the resumption of 3-months and one 6-months full allotment repos and the restoration of currency swap lines with all leading central banks, the announcement and subsequent actions of the ECB have convinced us that the primary focus of the ECB was not to save the EA sovereigns for their own sake, but to prevent a deepening sovereign debt crisis from causing a second leg of the EA banking crisis.

Indicative of the ECB's preoccupation with the banks, rather than with the sovereigns per se, was the ECB's decision to purchase Greek sovereign debt despite the Greek sovereign being 'out of the market' because of its access to the Greek loan facility. We expect the only reason to support the secondary market price of Greek sovereign debt was therefore to prevent a sharp decline in its price, which would have weakened the balance sheets of the creditors, notably French and German banks, to the extent that the debt had to be marked to market. Sovereign debt offered as collateral in ECB repos would, in the event of a secondary market price decline, give rise to margin calls, which would further undermine the profitability of the banks that owned it.

⁶ Of the €60bn covered bond facility, about €57bn has by now been used up (Source: ECB). The option to purchase a wider range of private securities through the Securities Markets Programme has not yet been exercised.

The ability to purchase any kind of private security also puts the ECB in a position to fund banks by direct purchases of their debt when they no longer have any collateral that meets the standards of the ECB repo facilities. Given the availability of €13.1 trillion worth of potentially of collateralisable assets (inside and outside the EA banks), of which only €2 trillion are currently used, such a case looks unlikely. Should the banks, despite the ECB's best efforts, cease to lend to the non-financial private sector, and should the corporate bond markets threaten to close down, the ECB could act as a version of Gosbank, by substituting itself for normal commercial buyers of non-financial corporate debt. All that is lacking is for the ECB to declare itself willing and able to make unsecured loans to the private sector, and we would have a stand-by monobank back-up for commercial banking in the EA.

**EFSF could become Eurosystem
counterparty – EIB already is ...**

Should it need funds in a hurry (that is, faster than it can access the bond markets) the EFSF, which is a limited liability company, could be made an eligible counterparty for the Eurosystem, enabling it to borrow from the ECB/Eurosystem, offering its own debt as collateral. If this is a bridge too far, the fact that the European Investment Bank (EIB) has been made a co-manager of the EFSF (together with the European Commission (EC)) comes in handy. The EIB – a development bank – would have no remit to manage a sovereign liquidity facility. The EIB does, however, have the capacity to borrow (effectively) under joint and several guarantee from the 27 EU members. In addition, the EIB was made an eligible counterparty of the Eurosystem in 2009, something that we find puzzling from the perspective of its traditional role as a development bank, but makes a lot of sense if the EIB is viewed as a potential conduit for short-term ECB/Eurosystem funds to worthy causes. The EFSF could now be added to the list as a “potential worthy” cause.

**Facility could morph from sovereign
liquidity fund into TARP Mark 2 bank
recapitalisation fund**

There are precedents for liquidity facilities being converted into sources of capital. The US Troubled Asset Relief Program (TARP) was designed as a facility to provide market liquidity for the purchase of illiquid assets from banks and other financial institutions that were deemed to be solvent provided they did not have to sell these illiquid assets at fire-sale, artificially depressed prices. When, after September 15, 2008 and the failure of Lehman and the near-collapse of AIG, it was discovered that much of the US cross-border banking system was insolvent, the TARP became a facility for recapitalising banks and other financial and non-financial enterprises. It is also significant that the Greek €110bn loan facility includes €10bn specifically earmarked for recapitalising Greek banks. We expect that the EFSF and the other funds contained in the EU/IMF Facility will be used, at least in part, in the same way; that is, to recapitalise banks in countries where the sovereign temporarily has restricted access to the debt markets or no access at all.

With banks joining sovereigns as claimants on the EU/IMF Facility (with the funds to the banks possibly routed via the sovereign– funds are fungible but appearances matter) the argument that the Facility is too small and will require at least €2 trillion is strengthened.⁷

⁷ €2 trillion was also the figure proposed by Peter Boone, Simon Johnson and James Kwak for their European Stability Fund, which would fulfil a role similar to the EFSF, but for the whole of the EU. See Boone, Johnson and Kwak (2008).

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Notes

Appendix A-1

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