

# **The role of ECB in relation to the modified EFSF and the future ESM**

Prof. Dr. iur. Dr. rer. pol. Peter Sester

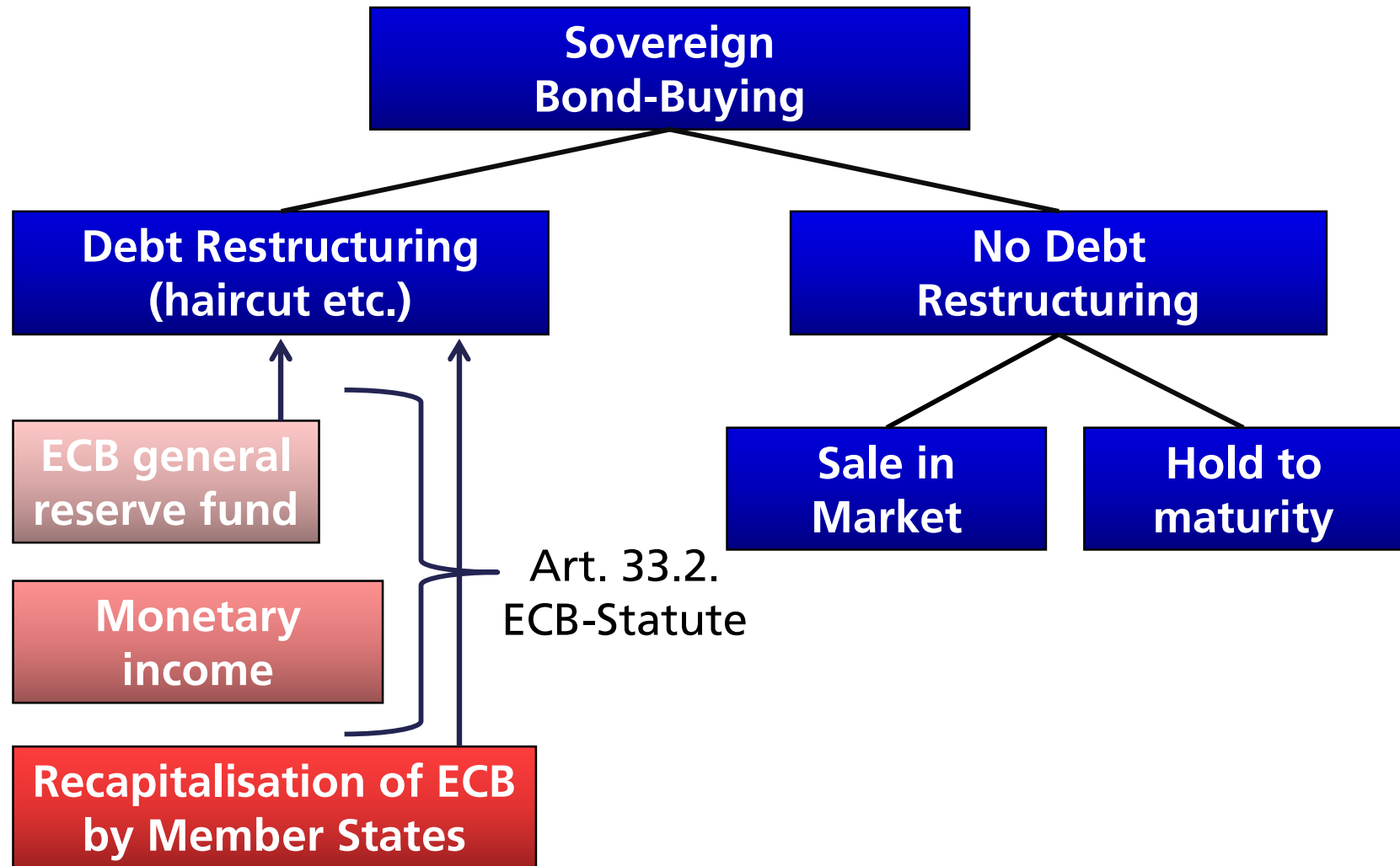
**“A monetary union with a stable euro can only survive if **central bank independence** is fully respected. This implies that the ECB **abstains from fiscal policy actions** (*such as the Securities Market Program = SMP*). Yet to change the “no bail-out” clause ever more in the direction of a **bail-out regime** is not a step towards a democratically-legitimised political union.”**

Otmar Issing (FT August 8, 2011)

## **Negative Impact of SMP on ECB's Long Term Credibility**

- **Mounting political pressure in case a sovereign default (waiver, haircuts).**
- **Need to absorb losses arising as a consequence of the SMP.**
- **Monetary stability depends on fiscal discipline, but SMP creates moral hazard in over-indebted member states.**

# SMP can become a major step towards a transfer union



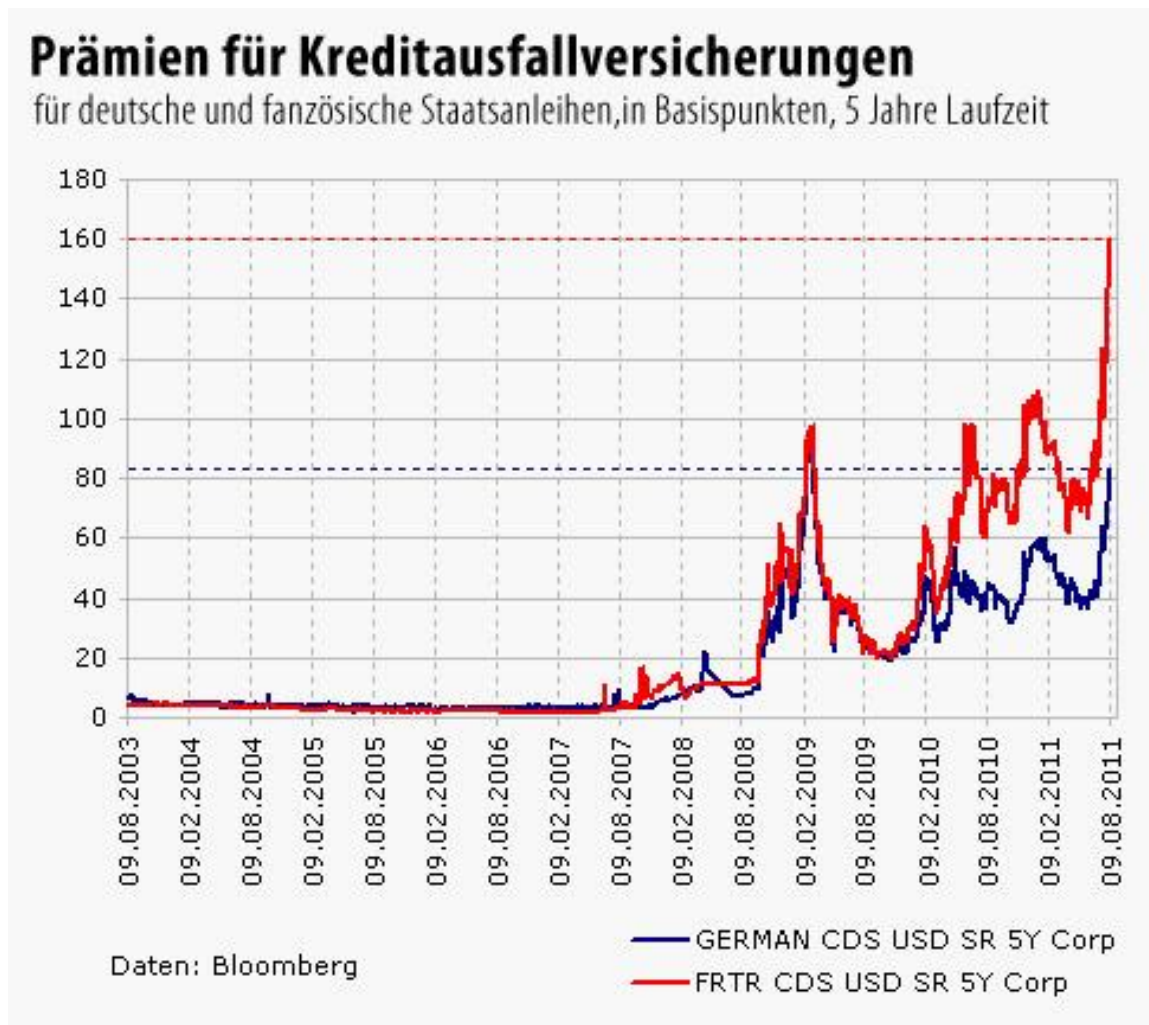
# Indicators for a Transfer Union (price of CDS for 5 years German bonds, basis points of nominal value)

## Prämien für Kreditausfallversicherungen

für deutsche Staatsanleihen, in Basispunkten vom Nominalwert, 5 Jahre Laufzeit



# Indicators for a Transfer Union (price of CDS for 5 years German and French bonds)



## **Four questions:**

- **Is there a legal basis for the SMP launched by the ECB?**
- **Will the revised EFSF and the ESM definitely replace the SMP?**
- **Is there an appropriate legal basis for the EFSF/ESM?**
- **Are there alternatives?**

## Four questions:

- **Is there a legal basis for the SMP launched by the ECB?**

**Yes!**

- **Will the revised EFSF and the ESM definitely replace the SMP?**
- **Is there an appropriate legal basis for the EFSF/ESM?**
- **Are there alternatives?**



## Legal Basis for SMP (according to ECB/2010/5)

- **Art. 127 (2) TFEU (equivalent to Art. 3.1 ECB-Statute):**

The basic tasks to be carried out through the ESCB shall be:

- to define and implement the **monetary policy** of the Union.

- **Art. 12.1 (2) ECB-Statute:**

The Executive Board shall **implement monetary policy** in accordance with the guidelines and **decisions laid down by the Governing Council**. In doing so the Executive Board shall give the necessary instructions to national central banks. (...)

- **Art. 18.1 ECB-Statute:**

In order to **achieve the objectives** of the ESCB and to carry out its tasks, the ECB and the national central banks may:

- **operate in the financial markets by buying and selling outright**

## Legal Basis for SMP (according to ECB/2010/5)

- **ECB-Decision May 14, 2010 (ECB/2010/5):**

“in view of the current exceptional circumstances in financial markets, characterised by **severe tensions in certain market segments** which are **hampering the monetary policy transmission mechanism and thereby the effective conduct of monetary policy** oriented towards price stability in the medium term, a temporary securities markets programme (...) should be initiated.”

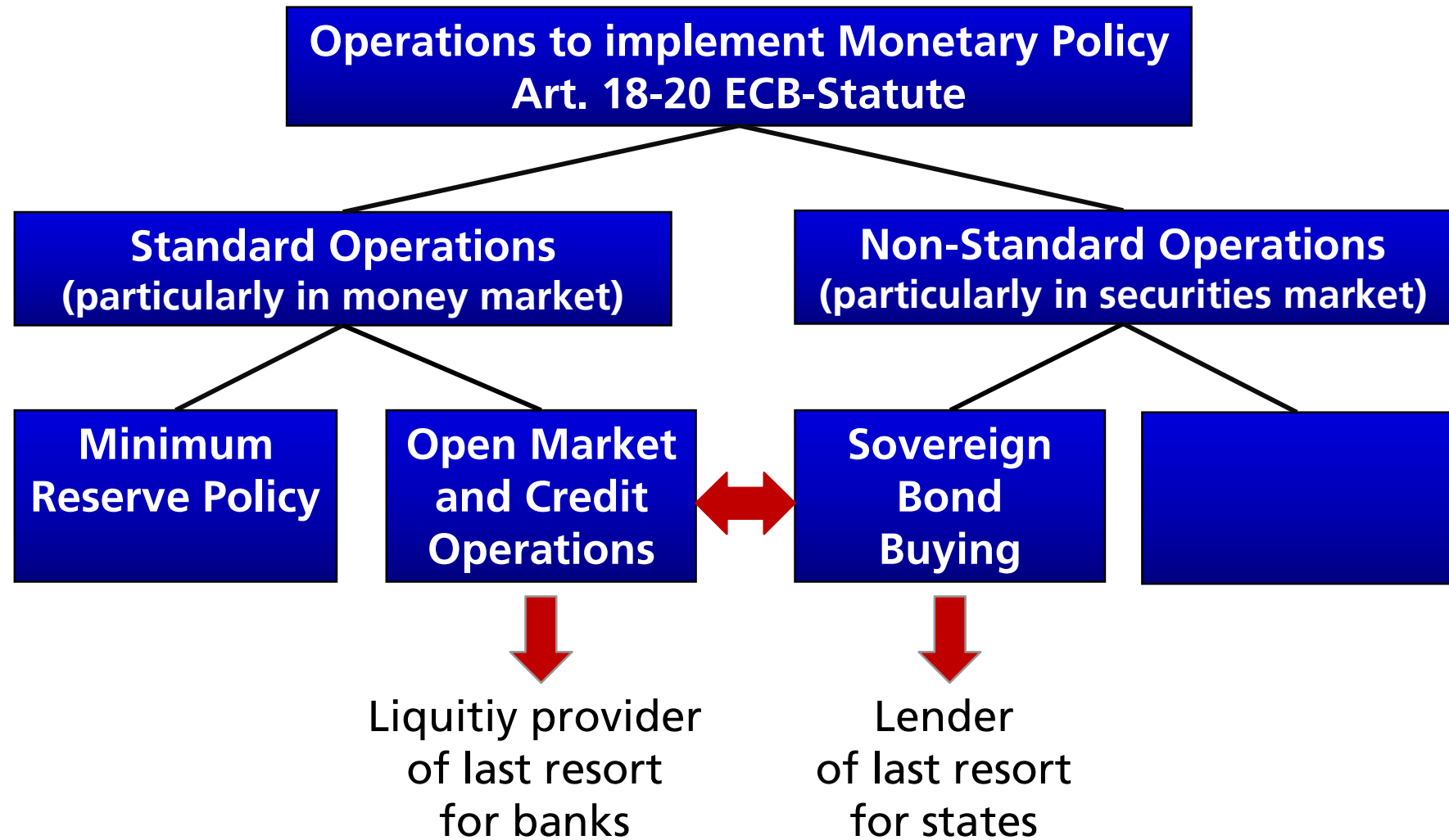
- **Art. 12.1 (1) ECB-Statute:**

The Governing Council shall formulate the monetary policy of the Community including, as appropriate, decisions relating to **inter-mediate monetary objectives**, key interest rates and the supply of reserves in the ESCB, and shall establish the necessary guidelines for their implementation.

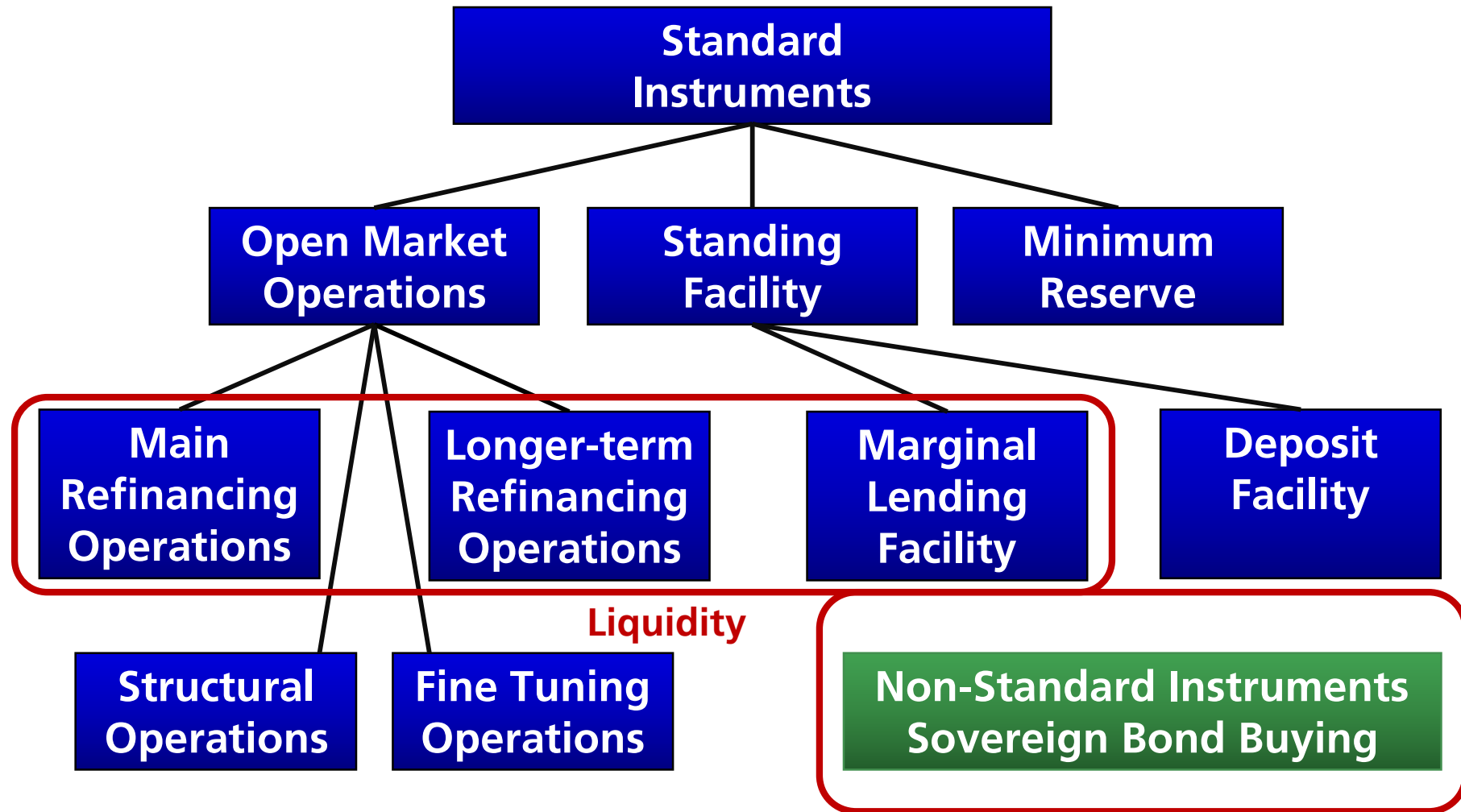
## Official statement by the President of the ECB when restarting SMP (August 7, 2011)

- “It equally considers fundamental that governments stand ready to **activate the European Financial Stability Facility (EFSF)** in the secondary market, **on the basis of an ECB analysis** recognising the existence of exceptional financial market circumstances and risks to financial stability, once the EFSF is operational.”
- In order to **keep the effects of the bond-buying neutral in terms of monetary policy**, the ECB is committed to **withdrawing an equivalent amount of liquidity from the money markets** every week to “sterilise” the process (Financial Times August 8, 2011).

# Monetary Functions and Operations of the ECB in terms of the TFEU and the ECB-statute



# Monetary Operations in Terms of the General Documentation on Euro-System Policy Instruments and Procedures



# Providing and Absorbing Liquidity

Monetary policy operation	Transactions providing liquidity	Transactions absorbing liquidity
<b>Main-refinancing instrument</b>	<b>Reverse Transaction (Weekly Tender)</b>	<b>(reducing the tender volume)</b>
Longer-term refinancing operations	Reverse Transaction (Monthly Tender for	-
<b>Fine tuning operation</b>	Reverse Transaction Foreign Exchange	<b>Collection of fixed term deposits, etc.</b>
Structural Operations	Reverse Transaction Outright purchase	ECB debt certificates Outright sale
Marginal Lending Facility	Reverse Transaction (unlimited)	-
Deposit Facility	-	Deposits
<b>Sovereign Bonds</b>	<b>Purchase</b>	<b>Sale</b>

## The ECB's capacity to "sterilise" effects of bond-buying

- But: What to do if the **interbank-market is distorted**?
- Without absorbing the "extra" liquidity the justifying argument that bond-buying serves **intermediate monetary objectives** becomes weak (but: "business judgement rule").

## Four questions:

- Is there a legal basis for the SMP launched by the ECB?
- **Will the revised EFSF and the ESM definitely replace the SMP?**  
**No!**
- Is there an appropriate legal basis for the EFSF/ESM?
- Are there alternatives?



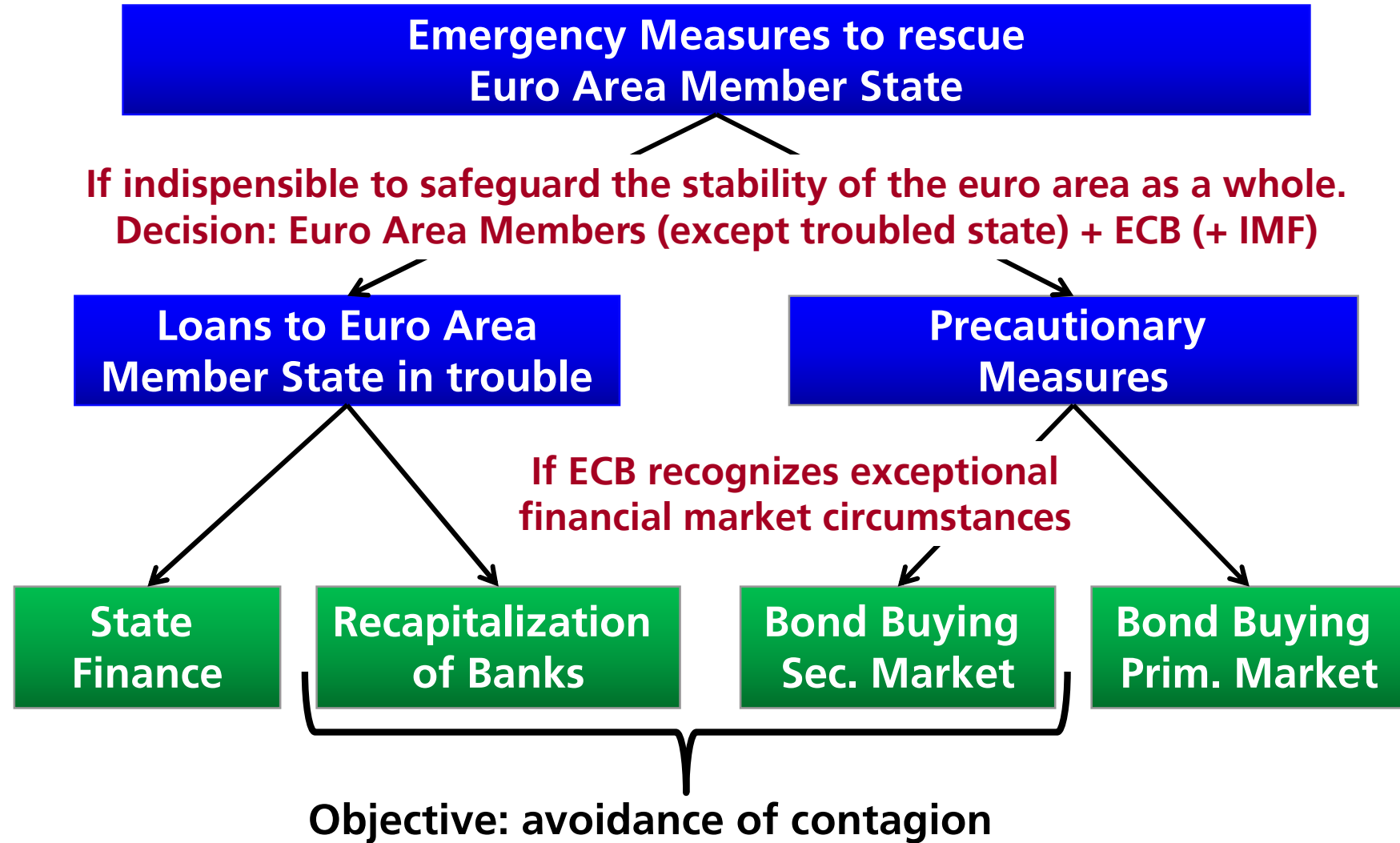
# From the (modified) European Stability Facility (EFSF) to the European Stability Mechanism (ESM)

- **Mid-2010 to September/2011: EFSF**
  - Financial assistance basically in the form of loans
  - EFSF loans rank “pari passu” with private sector claims
- **From January 2013 on: ESM**
  - Private sector involvement on the basis of CACs
  - Priority for ESM loans
- **October 2011 to January 2013: amended EFSF**
  - Competence to **buy bonds** in primary and **secondary market**
  - Recapitalize banks (etc.)

## Trichet 's comment on the modified EFSF and the ESM (Press conference August 4, 2011)

- “Of particular importance are the commitments undertaken (...) the flexibility that they have decided upon (*on the EU Summit on 21 July*) regarding the EFSF and the ESM, given the various areas where they have decided to create additional capacity, **including interventions on the secondary market through the EFSF which should, in our view, become operational as soon as possible.**”
- “As regards the EFSF, it is a decision (...) that when the EFSF intervenes in a secondary market, it would be **on the basis of an ECB analysis recognising the existence of exceptional financial market circumstances and risks to financial stability.** (...) Of course, what we expect is that the EFSF, which will have the capacity to intervene in the secondary markets, will be effective and efficient in its interventions. That would **permit us not to have to intervene to help restore more appropriate monetary policy transmission.**”

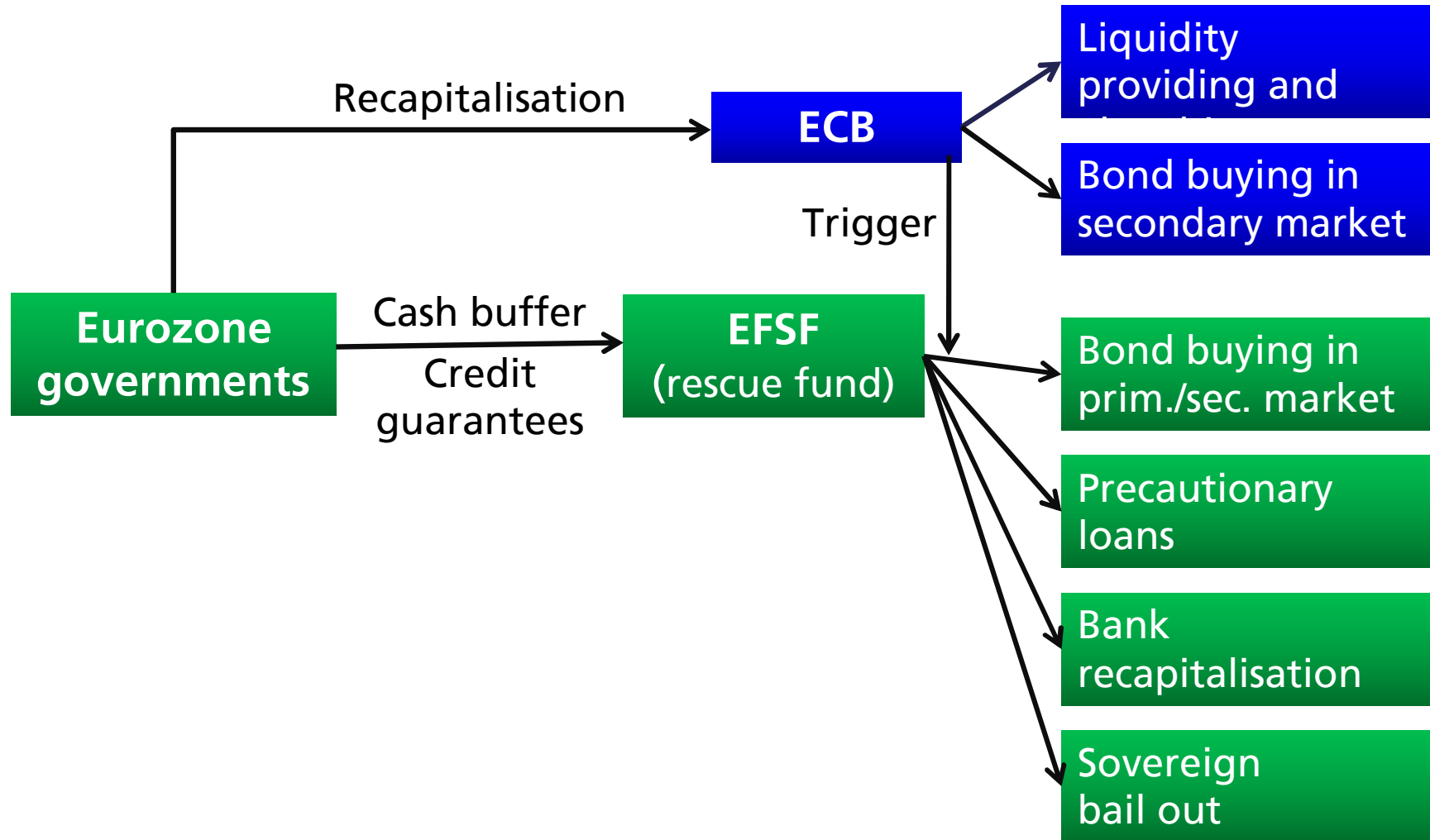
# The role of the ECB under the modified EFSF (ESM)



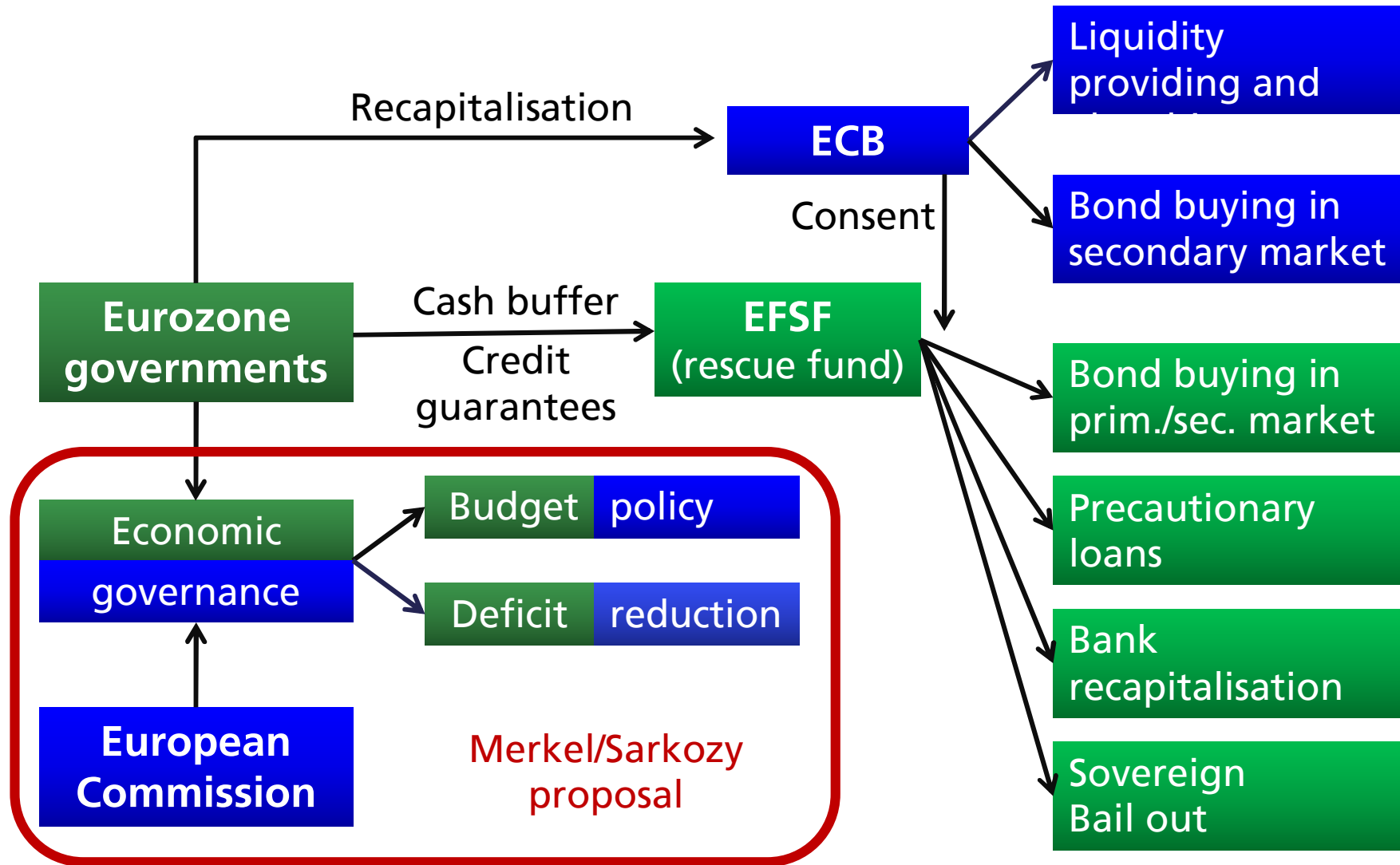
## Open questions after EFSF reform

- Will the modified EFSF clean up the ECB's balance sheet?
- What happens if the EFSF/ESM turns out to be too small?
- Are we on the way to an "illegal" bail-out regime?

# Crisis Governance after EFSF reform (I)



# State of Crisis Governance after EFSF reform (II)



## Critics

- **Daniel Gros (Center for European Policy Studies, FT 9/8/11):**

“The EFSF is big enough for the smaller states. **For Spain and Italy it has to be the ECB.**”

- **Paul de Grauwe (University of Leuven, FT 9/4/11):**

“Yet, the EFSF will never have the necessary credibility to stop the forces of contagion – precisely because it cannot actually print money. It depends for its resources on the member countries of the union, and these are limited. (...) Contagion between sovereign bond markets can only be stopped if there is **a central bank willing to be lender of last resort**. The only institution able to perform this role is the ECB.”

## Four questions:

- Is there a legal basis for the SMP launched by the ECB?
- Will the revised EFSF and the ESM definitely replace the SMP?
- Is there an appropriate legal basis for the EFSF/ESM?  
Yes (at least formally).
- Are there alternatives?



## Revision of the TFEU (the new Art. 136 III)

The Member States whose currency is the euro may establish a stability mechanism to be activated if **indispensable to safeguard the stability of the euro area as a whole**. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.

## Simplified revision of the Treaties (Art. 48 IV TEU)

The decision referred to in the second subparagraph **shall not increase the competences** conferred on the Union in the Treaties.

## Simplified revision of the Treaties (Art. 48 IV TEU)

- EFSF and ESM are not institutions established by the Treaties of the European Union
- Nature of the ESFS and the ESM:  
Intergovernmental institutions outside the Treaties.
- Legal construction:
  - a *société anonyme* incorporated in Luxembourg
  - full legal personality and capacity
  - contracting parties (eurozone countries) as sole shareholders
  - **exempted from any requirement to be authorised or licensed as a credit institution**, investment services provider or other authorised licensed or regulated entity

## **Rational and shortcomings of the institutional structure used for the EFSF/ ESM**

- **Rational of the institutional shift (“outsourced institutions”):**
  - Lack of time to amend the treaties.
  - Political risk inherent in each alteration of the treaties.
  
- **Shortcomings of the institutional shift:**
  - Need to redesign the EFSF (after only one year) via mutual consent of 17 national governments and parliaments.
  - Unclear relation to other EU institutions (ECB) and provisions of the European Treaties (no-bail-out clause).
  - Lack of democratic control on EU level.

## Four questions:

- Is there a legal basis for the SMP launched by the ECB? Yes.
- Will the revised EFSF/ESM definitely replace the SMP? No.
- Is there an appropriate legal basis for the EFSF/ESM? Yes.
- **Are there alternatives?**

(1) Daniel Gros / Thomas Mayer:

The **EFSF/ESM** should be converted into a **bank**.

(2) Jacques Delpla / Jacob von Weizsäcker (Bruegel Institute):

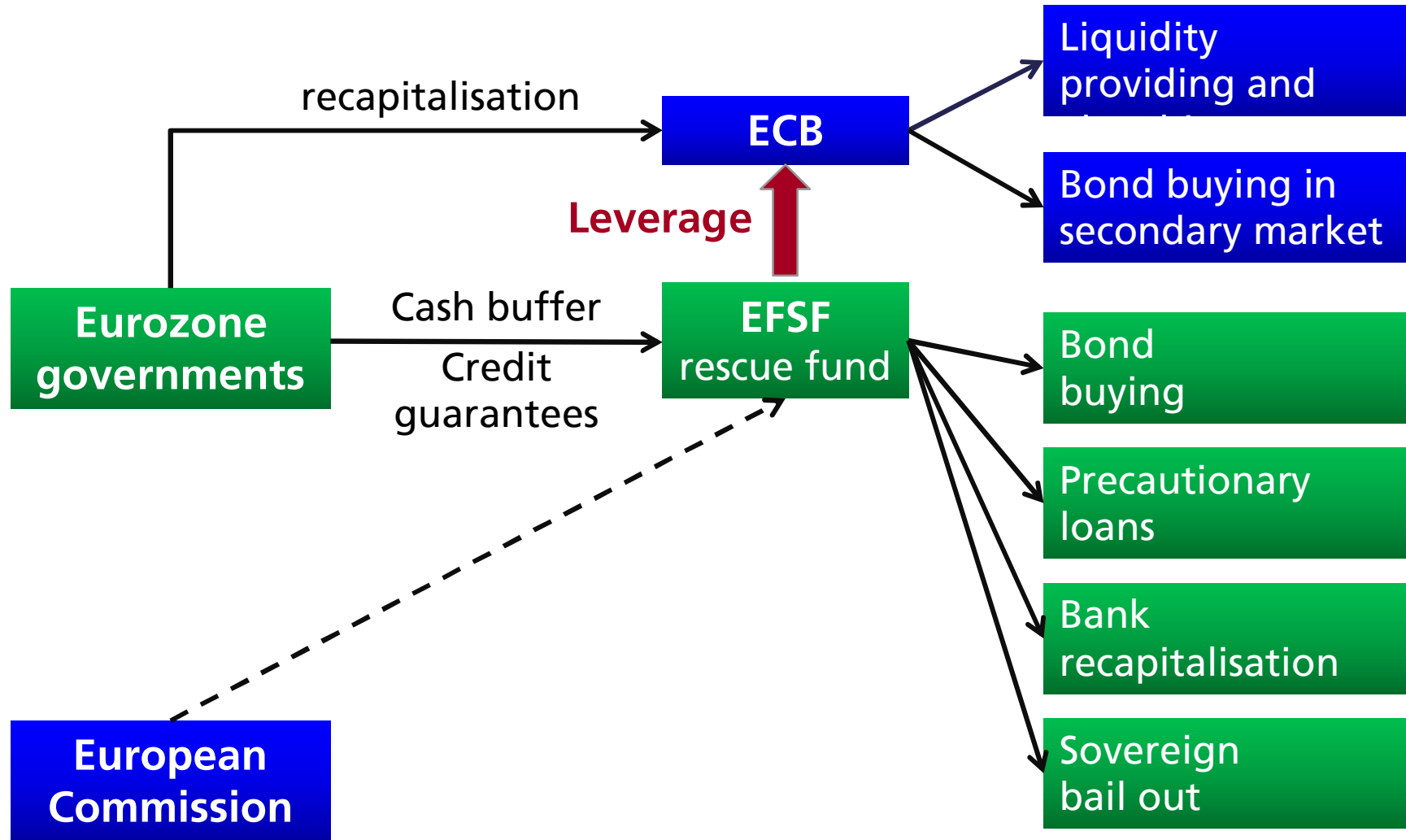
European Debt Agency issuing **Eurobonds**.

## CNBC September 27, 2011:

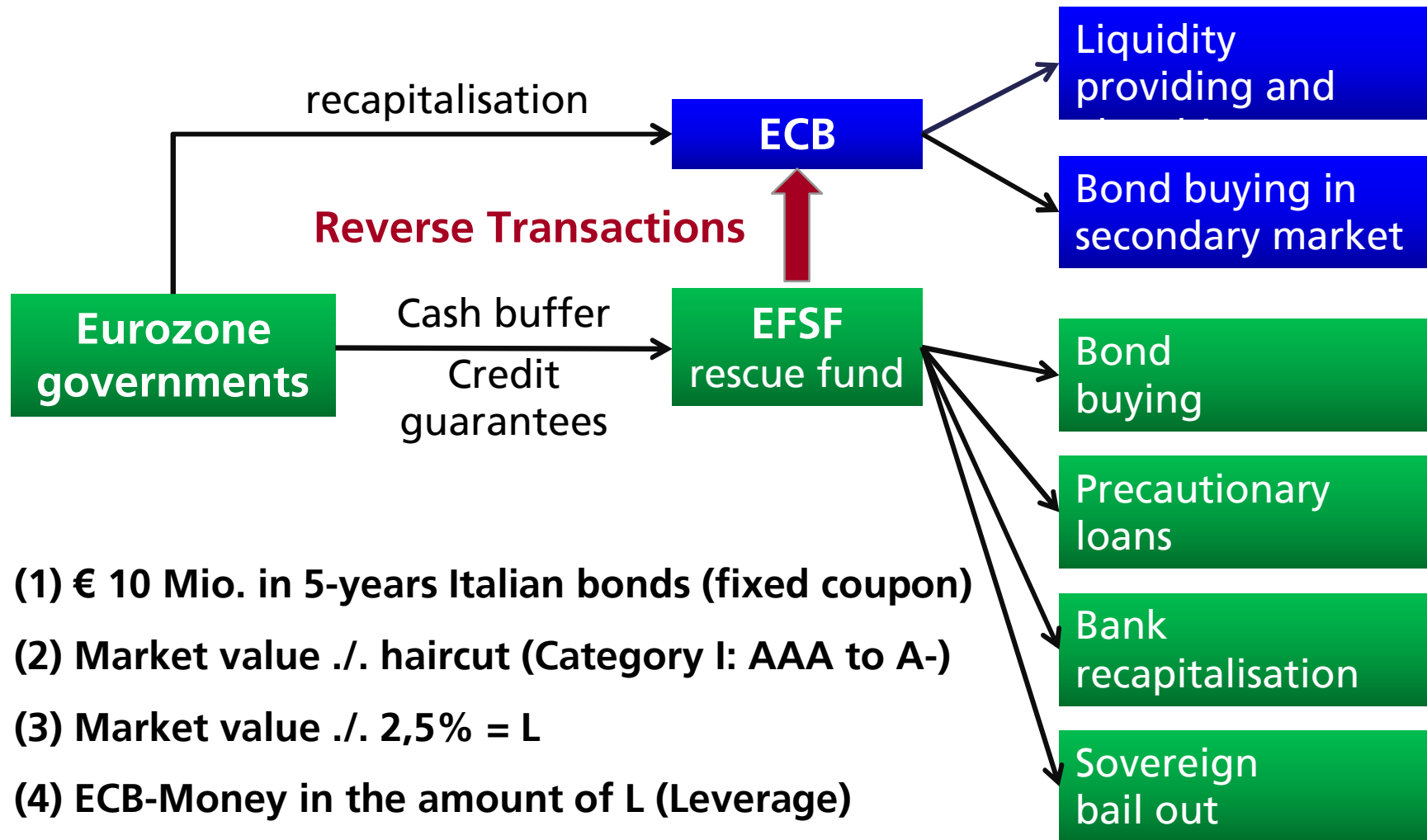
### 'Made in Washington' Plan For EU 'Too Little, Too Late'?

“If it is accepted that massive expansion of the EFSF through contributions by member-states is a non-starter on account of the near-impossibility of gaining parliamentary approval for such an approach, then the **EFSF** would need to have **recourse to leverage**. (...) Sources told CNBC of as much as an **8-to-1 leverage ratio** (...)”

# Alt. 1: Conversion of EFSF/ESM into a Bank

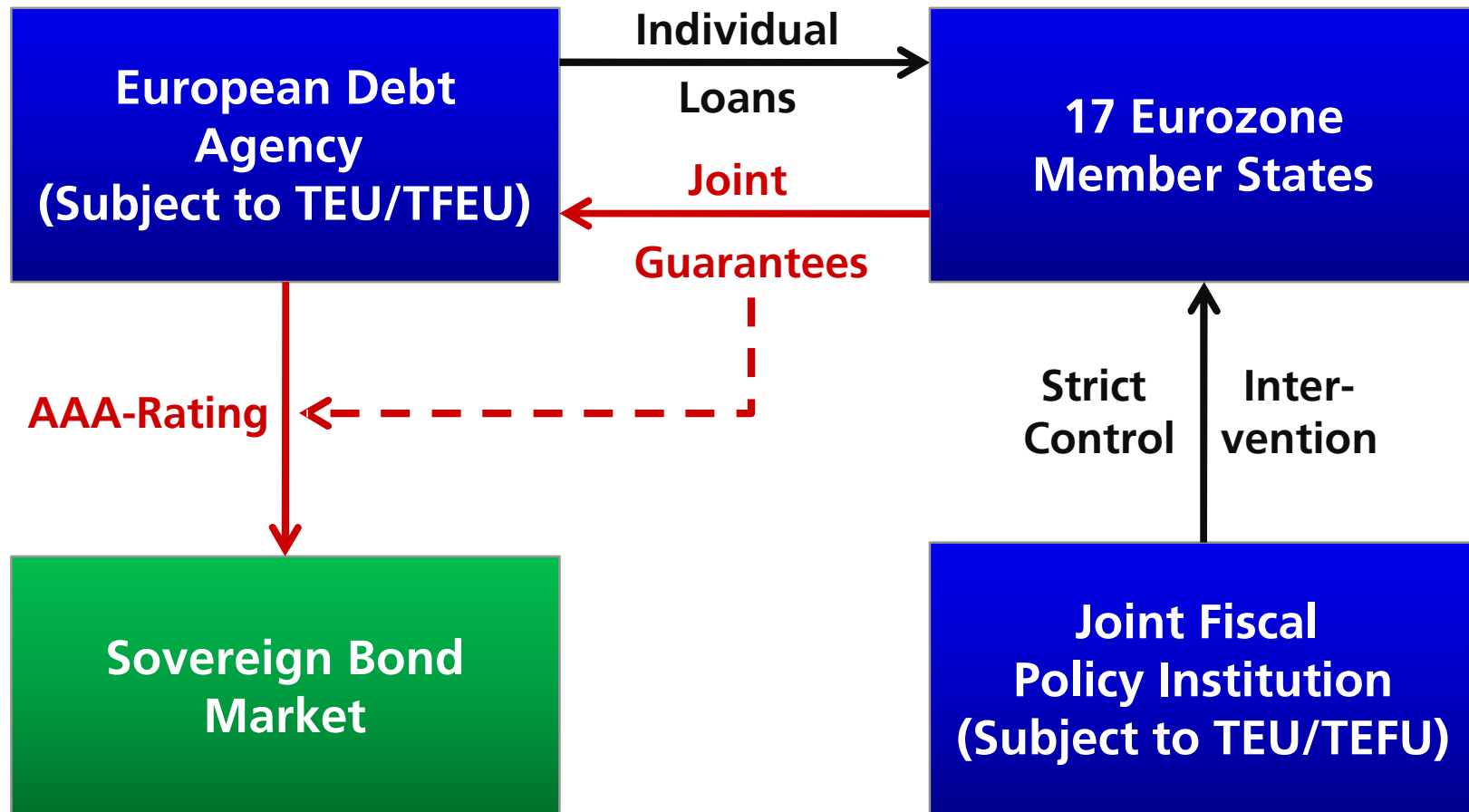


# Alt. 1: Conversion of EFSF/ESM into a Bank





## Alt. 2: Eurobonds and European Debt Agency (I) Possible Structure



## Alt. 2: Eurobonds and European Debt Agency (II) Rational

- Public finances of the eurozone as a whole are relatively good:

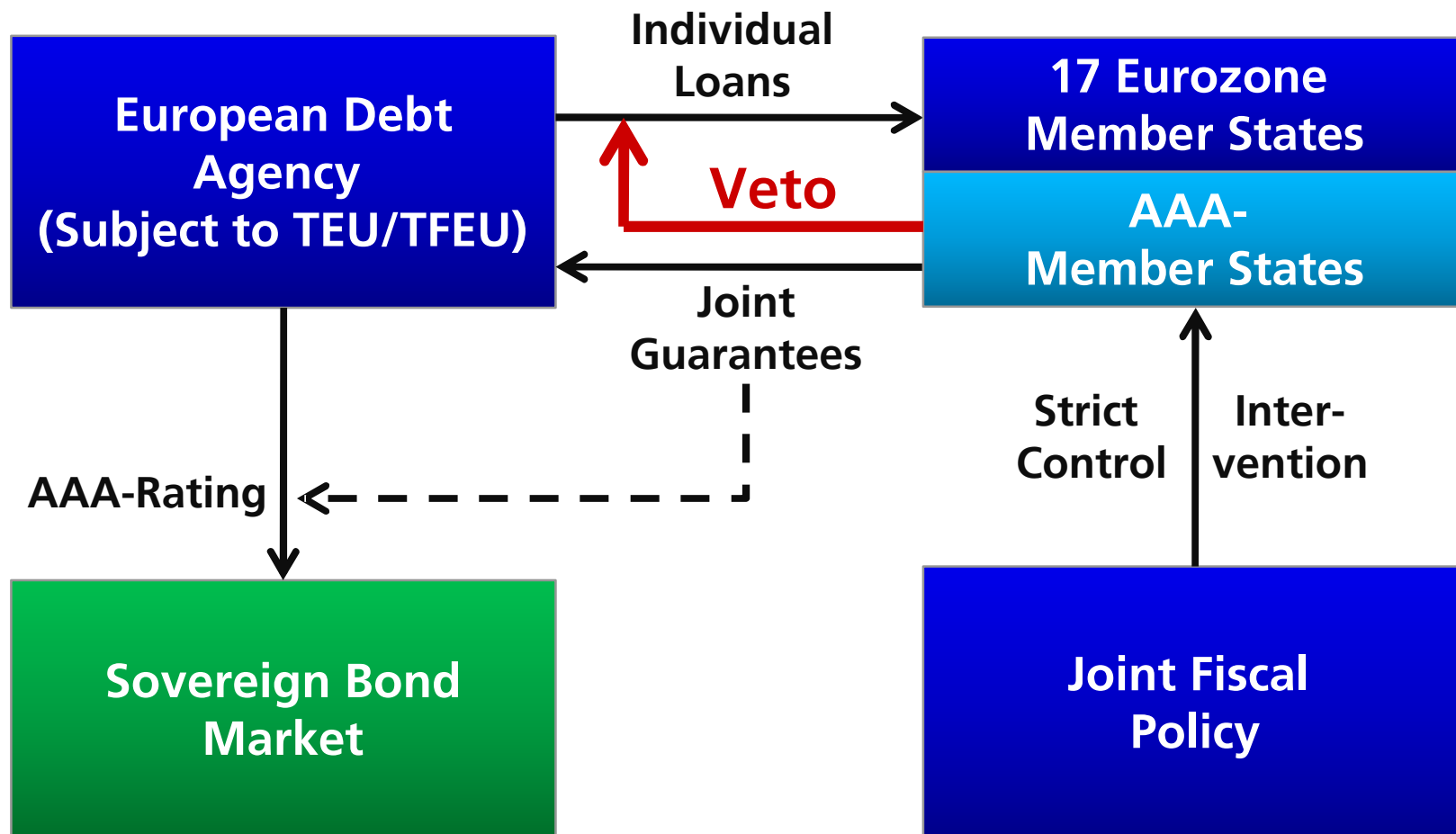
	Debt to GDP Ratio	Budget Deficit to GDP Ratio
Eurozone	88%	4%
USA	98%	10%
UK	83%	8,5%

- Creating the 2<sup>nd</sup>/3<sup>rd</sup> largest sovereign bond market in the world:
  - positive effect of extra liquidity on yields, and
  - high hurdle for downturn speculations.

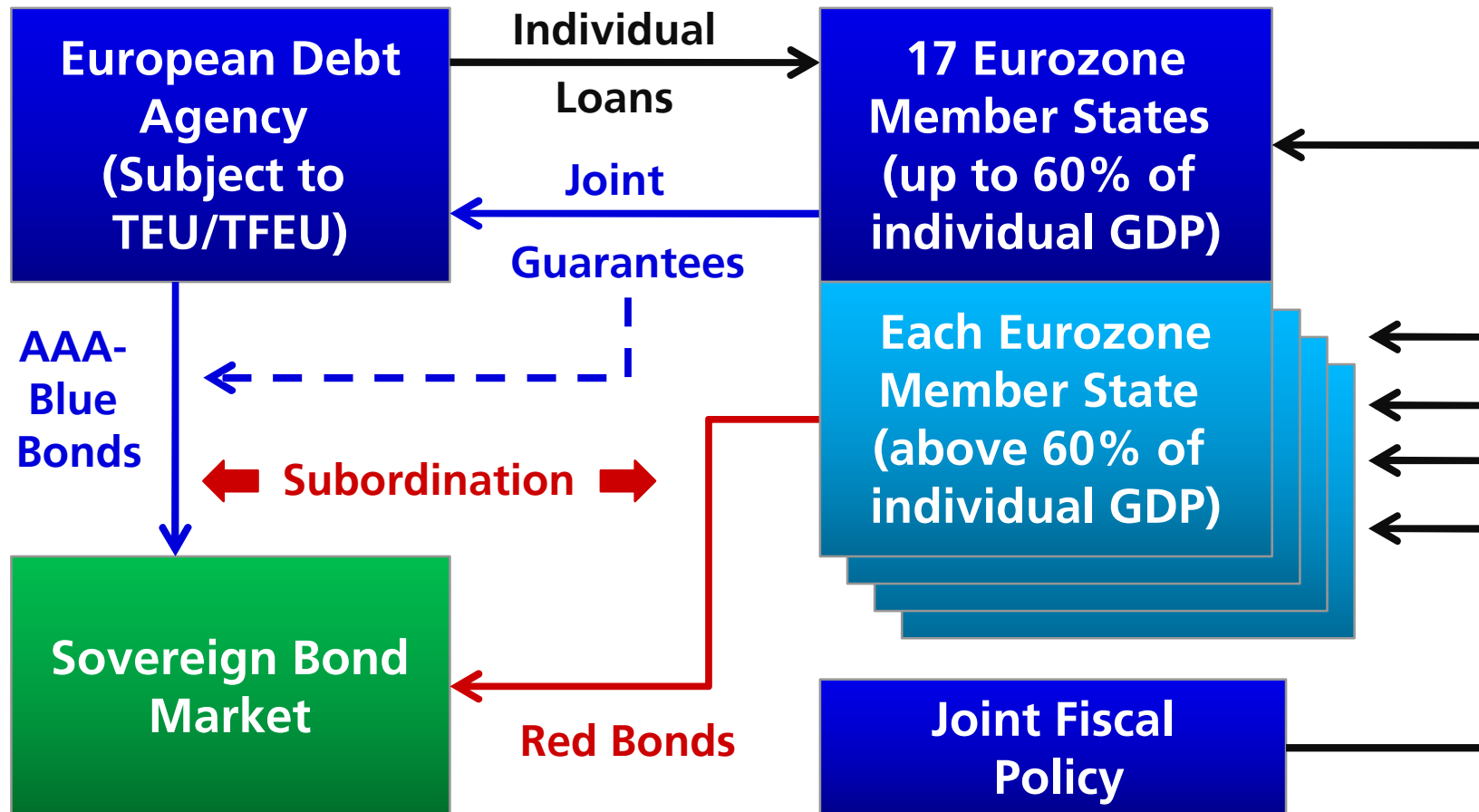
## Alt. 2: Eurobonds and European Debt Agency (III) Preconditions

- **Over-indebted countries need to return to sustainable debt level**
  - fiscal adjustment (austerity, more effective tax system etc.)
  - (tougher) haircuts (Greece, Portugal)
  - creditable "business model"
  
- **Breaking vicious circle of sovereign debt and bank restructuring:**
  - "(...) **tougher prudential rules on loss recognition** (*in the case of sovereign bonds*) **by banks** (CEPS Policy Paper by Micossi/Carmassi/Peirce)."
  - Reduce regulatory incentives for banks to buy sovereign bonds without true risk evaluation.
  
- **Safeguards against Moral Hazard**

## Alt. 2: Eurobonds and European Debt Agency (IV) Safeguards against Moral Hazard



## Alt. 2: Eurobonds and European Debt Agency (V) Safeguards Against Moral Hazard



# Summary and Outlook

- EFSF/ESM are (at least formally) conform to EU law, but will serve as an interim solution only. As soon as possible we should return to the EU treaties as the only source of European institutions.
- Clear separation of fiscal and monetary policy – no access for EFSF/ESM to ECB refinancing.
- Eurobonds issued by a European Debt Agency (integrated in the TEU/TFEU) will become reality, probably based on some kind of “blue bond / red bond” model and hopefully with a clear subordination.
- All these instruments and institutions must be guided by a joint fiscal policy on the basis of the European Treaties (harsh intervention rights). Full tax harmonization is neither needed nor desirable (Swiss model).

**Thank you!**

