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)
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 intermediate 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

**Operations to implement Monetary Policy**
Art. 18-20 ECB-Statute

- **Standard Operations** (particularly in money market)
  - Minimum Reserve Policy
  - Open Market and Credit Operations

- **Non-Standard Operations** (particularly in securities market)
  - Sovereign Bond Buying

**Liquidity provider of last resort for banks**

**Lender of last resort for states**
Monetary Operations in Terms of the General Documentation on Euro-System Policy Instruments and Procedures

- **Standard Instruments**
  - **Open Market Operations**
  - **Standing Facility**
  - **Minimum Reserve**
    - **Main Refinancing Operations**
    - **Longer-term Refinancing Operations**
    - **Marginal Lending Facility**
    - **Deposit Facility**
      - **Structural Operations**
      - **Fine Tuning Operations**
      - **Non-Standard Instruments**
        - **Sovereign Bond Buying**

Liquidity
## Providing and Absorbing Liquidity

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

- **Emergency Measures to rescue Euro Area Member State**
  - If indispensable to safeguard the stability of the euro area as a whole. Decision: Euro Area Members (except troubled state) + ECB (+ IMF)

- **Loans to Euro Area Member State in trouble**
- **Precautionary Measures**
  - If ECB recognizes exceptional financial market circumstances

- **State Finance**
- **Recapitalization of Banks**
- **Bond Buying Sec. Market**
- **Bond Buying Prim. Market**

Objective: avoidance of contamination
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)

Eurozone governments → EFSF (rescue fund) → ECB

Recapitalisation

Cash buffer
Credit guarantees

Trigger

Liquidity providing and absorbing
Bond buying in secondary market
Bond buying in prim./sec. market
Precautionary loans
Bank recapitalisation
Sovereign bail out
State of Crisis Governance after EFSF reform (II)

- Eurozone governments
  - Cash buffer
  - Credit guarantees
  - Economic governance
    - Budget policy
    - Deficit reduction
  - European Commission
    - Merkel/Sarkozy proposal

- ECB
  - Recapitalisation
  - Consent

- EFSF (rescue fund)
  - Bond buying in primary/secondary market
  - Precautionary loans
  - Bank recapitalisation
  - Sovereign Bail out

- European Commission
  - Economic governance
  - Budget policy
  - Deficit reduction

- ECB
  - Consent

- Bond buying in primary/secondary market
  - Precautionary loans
  - Bank recapitalisation
  - Sovereign Bail out

- Merkel/Sarkozy proposal
  - Economic governance
  - Budget policy
  - Deficit reduction
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 / Jocob von Weizsäcker (Bruegel Institute):

European Debt Agency issuing Eurobonds.
'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

Eurozone governments

Cash buffer
Credit guarantees

Eurozone governments

ECB

recapitalisation

Leverage

Bond buying

Bond buying in secondary market

Liquidity providing and
absorbing

EFSF rescue fund

Eurozone governments

European Commission

Precautionary loans

Bank recapitalisation

Sovereign bail out

Bond buying in secondary market

Leverage

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

- **Eurozone governments**
  - Reverse Transactions
  - Cash buffer
  - Credit guarantees

- **EFSF rescue fund**
  - Bond buying
  - Precautionary loans
  - Bank recapitalisation
  - Sovereign bail out

- **ECB**
  - Liquidity providing and absorbing
  - Bond buying in secondary market

(1) € 10 Mio. in 5-years Italian bonds (fixed coupon)
(2) Market value ./. haircut (Category I: AAA to A-)
(3) Market value ./. 2,5% = L
(4) ECB-Money in the amount of L (Leverage)
Alt. 2: Eurobonds and European Debt Agency (I)
Possible Structure

European Debt Agency (Subject to TEU/TFEU) → Individual Loans → Joint Guarantees

AAA-Rating ← Joint Fiscal Policy Institution (Subject to TEU/TEFU)

17 Eurozone Member States

Strict Control

Inter-vention
Alt. 2: Eurobonds and European Debt Agency (II)
Rational

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

<table>
<thead>
<tr>
<th></th>
<th>Debt to GDP Ratio</th>
<th>Budget Deficit to GDP Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eurozone</td>
<td>88%</td>
<td>4%</td>
</tr>
<tr>
<td>USA</td>
<td>98%</td>
<td>10%</td>
</tr>
<tr>
<td>UK</td>
<td>83%</td>
<td>8.5%</td>
</tr>
</tbody>
</table>

- Creating the 2\textsuperscript{nd}/3\textsuperscript{rd} 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

- European Debt Agency (Subject to TEU/TFEU)
- 17 Eurozone Member States
- AAA-Rating
- Joint Fiscal Policy
- Sovereign Bond Market

Safeguards:
- Joint Guarantees
- Joint Fiscal Policy
- Strict Control
- Intervention
- Veto

Individual Loans

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

- European Debt Agency (Subject to TEU/TFEU)
  - AAA-Blue Bonds
  - Individual Loans
  - Joint Guarantees
  - Subordination
- 17 Eurozone Member States (up to 60% of individual GDP)
- Each Eurozone Member State (above 60% of individual GDP)
- Joint Fiscal Policy
- Sovereign Bond Market
- Red Bonds
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 theses 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!