Europe's non-solution: the 'bazooka' turned on itself

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To judge from the euphoric actions of the equity markets recently, it would appear that Europe's policy makers have finally grasped the nettle, and resolved the problems of the European Monetary Union (EMU) once and for all. And when have we heard that before? Truth be told, it is hard to get excited about any of the "solutions" on offer, because they steadfastly refuse to acknowledge that the eurozone's problem is fundamentally one of flawed financial architecture. The banking "problems", and corresponding "need" for urgent recapitalization, are simply symptoms of that problem. Offering the "cure" of banking recapitalization for a disease which is ultimately one of national solvency (of which the banking crisis is but a symptom) is akin to offering chemotherapy to resolve a heart ailment. It might look like the doctor is offering good medicine, but it does not address the underlying problem. By the same token, despite the current "thumbs-up" from the equity markets in response to last week's agreement, the treatment is likely to exacerbate the disease, rather than represent the cure. And the price action in Italy's bond auction in the aftermath of the latest "solution" does suggest something far more ominous.

Coming back to core principles. We agree that the concern about Portugal, Ireland, Italy, Greece and Spain (PIIGS), indeed ALL other Euronations is justified. But using PIIGS countries as analogues to the US is a result of the failure of deficit critics to understand the differences between the monetary arrangements of sovereign and non-sovereign nations. Greece, Italy, France, and yes, Germany, are all USERS of the euro—not an issuer (as is the US or, say, Canada). In that respect, they are more like California, Massachusetts, indeed, any American state or Canadian province, all of which are users of their respective national government's dollar.

But the eurozone's chief policy makers continue to ignore this fundamental point and therefore, steadfastly avoid utilizing the one institution – the European Central Bank – which has the capacity to create unlimited euros, and therefore provides the only credible backstop to markets which continue to query the solvency of individual nation states within the euro zone. They are, as Professor Paul de Grauwe suggests, like generals who refuse to go into combat fully armed ("European Summits in Ivory Towers" - http://www.voxeu.org/index.php?q=node/7158):

> The generals… announce that they actually hate the whole thing and that they will limit the shooting as much as possible. Some of the generals are so upset by the prospect of going to war that they resign from the army. The remaining generals then tell the enemy that the shooting will only be temporary, and that the army will go home as soon as possible. What is the likely outcome of this war? You guessed it. Utter defeat by the enemy.
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> The ECB has been behaving like the generals. When it announced its programme of government bond buying it made it known to the financial markets (the enemy) that it thoroughly dislikes it and that it will discontinue it as soon as possible. Some members of the Governing Council of the ECB resigned in disgust at the prospect of having to buy bad bonds. Like the army, the ECB has overwhelming (in

> fact unlimited) firepower but it made it clear that it is not prepared to use the full strength of its money-creating capacity. What is the likely outcome of such a programme? You guessed it. Defeat by the financial markets.

By the same token, the ECB is so loath for everybody to agree on a Greek default, on the grounds that they bear "the loss" even though it is a notional accounting loss that has no bearing on their ability to create euros until the cows come home. By contrast, when you get national governments funding the European Financial Stability Fund (EFSF), then it does ultimately threaten the credit ratings of France and Germany once the markets begin to call their bluff on how far they're prepared to go to support this political fig-leaf called the EFSF. And because NONE of these countries is sovereign in respect to their currency (they USE the euro, but they don't ISSUE it), it expands the potential insolvency problem, taking Germany down along with the rest.

Other than the obvious screams of “Weimar”, and “hyperinflation” is there any other reason to explain the ECB’s reluctance to continue its existing bond buying programs? Questions have been raised both about the ECB’s ultimate solvency and the legal constraints which govern its mandate. To deal with the solvency issue first: has anyone bothered to ask themselves what the concept of solvency means for a central bank that creates its own money? If one takes the 30 seconds required to ponder this question, surely we can understand that the concept of solvency is totally and thoroughly irrelevant to a central bank with a sovereign currency (i.e. not convertible on demand into a fixed quantity of other currencies or a commodity). Willem Buiter noted in his 2008 Discussion Paper – Can Central Banks Go Broke? – that in “the usual nation state setting” there is a unique “national fiscal authority” (treasury) which “stands behind a single national central bank”. He concludes in this situation that:

> There can be no doubt … the fiscal authorities are, from a technical, administrative and economic management point of view, capable of extracting and transferring to the central bank the resources required to ensure capital adequacy of the central bank should the central bank suffer a severe depletion of capital in the performance of its lender of last resort and market maker of last resort functions.

Does this mean that central banks cannot go broke? Answer: no. Willem Buiter provides the qualification that is essential:

> [T]he central bank can always bail out any entity – including itself – through the issuance of base money – if the entity’s liabilities are denominated in domestic current and nominally denominated (that is, not index-linked). If the liabilities of the entity in question are foreign-currency-denominated or index-linked, a bail-out by the central bank may not be possible.

Which is the standard definition of a risk-free sovereign government – one that only issues liabilities in its own currency. If the consolidated government sector – the central bank and the treasury – issue liabilities (for example, take on debt) – that is denominated in a foreign currency, then insolvency becomes a possibility.

What about the Eurozone, where there is no fiscal authority? In the Eurozone, the pecking order is that the member state treasuries are deemed to guarantee their own national central banks which “own” the ECB and which provide lender of last resort facilities to their

own banking systems. There is no fiscal authority backing the ECB but despite all the legal niceties (complexities) involved in how the national central banks might carry out their lender of last resort duties, the reality is that the ECB is the ultimate lender of last resort in the EMU
The other point to note is the following:

> [It] is not necessarily the case that a central bank goes bankrupt even if its equity capital is completely depleted by its engagement in unorthodox monetary policies. The reason is that there are differences between central banks and commercial banks and a static visual inspection of the central bank balance sheet does not convey a complete picture. http://bilbo.economicoutlook.net/blog/?p=1610

Consider the example of the US Federal Reserve which could buy up the entire outstanding stock of privately held US Federal debt today, i.e. it could be able to monetise the public debt and if the Fed loses capital it will not go bankrupt like a regular company: it will just print the money to make up the difference – and this is meant literally.

Similarly, the ECB cannot go bankrupt according to common comprehension because it is sitting at the fountain-head of money which it can create by itself. Something else logically flows from this analysis. As the monopoly supplier of currency, the ECB (like the Fed) can always determine price. Yet when it announced its programme of government bond buying it made it known to the financial markets (the enemy) that it thoroughly disliked it would discontinue it as soon as possible. That turns a potential bazooka into a pea-gun.

While the mainstream economists would consider this to be dangerously inflationary if the central bank acted in this way the point is that at least that observation (erroneous or not) takes the debate beyond the inane level of insolvency. The ECB and others who resist its involvement in the salvation of the common currency continue to think and act as if it is a central bank operating under a gold standard. That is insane, and certifiably so.

In regard to the legal requirements:

- The ECB does not have a statutory minimum capital requirement.
- It transfers profits to national governments but in times of losses it can only request a capital injection should its capital be depleted.
- The European Council (which is representative of elected governments) is not compelled to accede to this request.
- Hence, the ECB is a perfect balance sheet to warehouse risk since its losses need not become fiscal transfer as it can rebuild its profits via seigniorage over a number of years. In that sense, its role is analogous to that of the Swiss National Bank effectively warehoused its Swiss banks' bad paper during the height of the crisis in 2008.

Of course, the ECB would HATE this and the risk is that its losses would limit its willingness to maintain its bond buying program. But it remains the only game in town. The bond buying is precisely what gives them leverage and, paradoxically, preserves the quality of its balance sheet, since the purchases themselves ensure that the distressed bonds of countries such as Greece do not lose value because the ECB prevents them from defaulting. As brutal as it sounds, the ECB effectively uses the income of the Greeks (and others) to rebuild its capital base.

The minute the EFSF is introduced (as it apparently will be in November), along with the notion of haircuts, the ECB loses its leverage and the credit risk contagion shifts to the core countries of the EU, which WILL threaten their AAA ratings.

It also means this whole issue of banking recapitalization is a big red herring. In reality, banks don't really need recapitalization. What most depositors care about is being able to get their deposit money out of their bank, so whether they are solvent or not is not their primary concern. Arguably, all of the US banks were insolvent in 1982, but the FDIC guarantees worked to stabilize the system.

Bank capital is always available at a price. The 'market process' is for net interest margins to widen to the point where earnings attract capital. Except this all assumes credit worthiness isn't an issue.

The problem with current policy is that it is turning both the public and private sector into a 'credit event' which will make it extremely difficult for the borrowers to switch lenders. The market pressures are most acute today in respect of Greece, but the broader concern is that speculators will eventually look toward the bigger PIIGS, such as Italy, and this is where the issue of the European Financial Stability Fund's structural weaknesses come into play. This is ludicrous: Italy has been told to reach a balanced budget by 2013, even though it already has a primary surplus, and one of the lower debt levels (public and private) in the OECD club – lower than AAA rated France, in fact, according to Albert Edwards of Societe Generale. The anticipated austerity policy being forced on the Italians risks pushing the country into a slump that could set off the destructive debt dynamic so feared, as has just occurred in Greece.

Let us not get bogged down in numbers. The EFSF could have 440 billion euros behind, 1 trillion, 2 trillion, even 10 trillion euros, but it all comes back to the funding sources. The French are right: it makes no sense to implement this program without the backstop of the ECB, which is the only entity that could make any guarantees credible, by virtue of its ability to create unlimited quantities of Euros, as Paul de Grauwe forcefully argues.

Both the leading policy makers within the euro zone and market participants continue to conflate two distinct, but related issues: that of national solvency and insufficient aggregate demand. Policy makers want the ECB to do both, but in fact, the ECB is only required to deal with the solvency issue. When you do that in a credible way, then you get the capital markets re-opened and you give countries a better chance to fund themselves again via the capital markets. It means you do not actually need several trillion dollars, because you have a credible backstop in place – a central bank that can create literally trillions of euros via keyboard strokes and thereby address the markets' concerns about national solvency. At this point, the bonds of the various nation states become less distressed and the corresponding need for massive banking recapitalization goes away.

Banking recapitalization is being demanded because the eurozone keeps demanding "voluntary" hair cuts" on Greek debt. The 50% haircut is "voluntary" to the extent that a bank teller "voluntarily" gives up money from the bank vaults to someone who points a gun at him/her. And restructuring Greece's debt in this manner will not end Europe's crisis and will not allow Germany and other core nations to brush themselves off and move merrily on their way. Instead, it ultimately extends the contagion effect to the core countries, because – via the EFSF – they are now in the debt guarantee business.

Getting France and Germany into the sovereign debt guarantee business via the EFSF (which is what happens if the ECB has no role) ultimately contaminates their own national "balance sheets", thereby causing the markets to query their solvency as well and extending the contagion effects well beyond the PIIGS. We will have a situation akin to Ireland, whereby a country which had fundamentally solid government finances taken down via ill-considered guarantees to its insolvent banking system. Peripheral EMU is to core EMU as Irish banks once were to Ireland. By getting into the guarantee business, Ireland drove down a policy cul de sac from which it is still trying to extricate itself and smeared itself with correlated risk that required it to seek a bailout.

By contrast, were the ECB to continue to fund Greece via its bond purchases and not allow Athens to default, then Greece would continue to make these payments. But the ECB has this weird idea that somehow continuing their bond buying operation allows Greece (and other "fiscal deviants") to avoid their "fiscal responsibilities" (i.e. continued fiscal austerity). The reality (however misguided), is that the bond buying operations actually provide the ECB with its leverage to force Greece and others to continue their "reforms". It means ECB can buy sufficient quantities of Greek bonds in the secondary markets to allow Greece to fund itself in the short term markets at reasonable interest rates. And it gets even better than that for the ECB, as the ECB also substantially enhances its profitability by continuing to buy deeply discounted Greek bonds and using Greece's income stream to build the ECB's stated capital. As long as it continues to buy Greek debt, Greece remains solvent, and the ECB continues to increase its accrual of profits that flow to capital.

In the current environment you have a solvency crisis which is feeding into the banking system because a large proportion of their assets are Euro denominated government bonds. Going down the path of "voluntary" hair cuts and forced recapitalization will simply set off a massive debt deflation spiral. We will see bank's fire selling assets left and right - management will not issue equity at these miserably low price to book values. Which in turn will depress economic activity even further, widen the very public deficits which are so exorcising the Eurozone's policy making elite, and bring us back to Square One. Already the guns are being turned on Italy, now that Greece is on the threshold of being "solved".

Bond buying by the ECB has hitherto changed the whole dynamic from doing Greece a favor to disciplining Greece by not allowing them to default and allowing the ECB to collect a significant income stream from the Greeks in the meantime. This is all gone with the new "final solution". With the haircuts, and the cessation of a bond buying role for the ECB, what is the incentive for ongoing Greek compliance? More to the point: what is to stop the other "problem children" from demanding the same terms, despite protestations from the deal's architects that Greece is a "one-off".

What is amazing as one listens to the commentary is the number of people who keep defining this as a banking crisis. Worse is the commentary which suggests a desire to punish the banks, all of which were told at the Euro's inception that one national bond was as good as another. The system would not have functioned (or, rather, its flaws would have become manifest sooner) if the national banks had proceeded on the basis that, say, Italian bonds were not as good as German bunds. But today, the rules are being re-written and the “irresponsible” bankers are to be punished.

True, many bankers have been irresponsible in a multitude of areas, many of which have already been documented in numerous blogs and newspapers. Fraud, dodgy financial engineering, shady accounting, these are all areas where the banks could and should be disciplined. But here they are being punished for the wrong things. This is ultimately a national solvency crisis, not a banking crisis, so how does punishing the bankers and their shareholders help here?

Everybody in Europe, save the Germans, appears to understand this right now. Until the last German “Nein”, the French held out for an ongoing role for the ECB. This was nixed in Berlin. Why? Every time something unconventional is urged on the Germans, they scream "Weimar". One of the indicators of development - intellectual and national and otherwise is to appreciate history and be able to decompose it into components.

The Germans appear unable to make that simple distinction. But if we think about the Weimar Republic for a moment, the problems for Germay began long before the hyperinflation, which really went off in 1923. In a sadly ironic parallel to what the Mediterranean periphery countries (Greece, Spain, soon, Italy) are facing today, the reparations payments following World War I required under the Versailles Treaty squeezed the Berlin government so badly that they eventually defaulted. The Treaty was just a bloody-minded pay-back by the victors of the war.

Undoubtedly, the Reichsbank had a hand in the Weimar hyperinflation, having become accustomed to “monetizing” German government debt during the WWI after gold convertibility was severed. However, while price levels quintupled between the armistice and February 1920, currency in circulation only doubled, leading many politicians to blithely claim monetary policy could not be blamed for inflation. An increase in money velocity must have played a role, although the monetary arrangements of the Reichsbank became increasingly suspect.

The Reichsbank had pegged the discount rate at 5%, and accepted private commercial debt for discounting under what was known as the real bills doctrine of the time. Money creation to finance production was not believed to carry an inflationary impulse. Direct loans to businesses were ramped up by the central bank after December 1921 when private financial institutions began to withhold credit as inflation accelerated. The assassination of Foreign Minister Rathenau in 1922 set off a selling spree by foreign investors of German bonds, and the central bank was once again forced to offset the run with more purchases of German government obligations.

Central bank mayhem aside, the final culminating chapter of the Weimar hyperinflation does appear closely related to the response to reparation demands. The May 1921 so called London ultimatum required annual installment payments of $2b in gold or foreign currency, in addition to a claim on just over a quarter of the value of German exports. Germany attempted to accumulate foreign exchange by paying with treasury bills and commercial debts denominated in Marks, but the Mark simply went into free fall on foreign exchange markets as this ploy fell flat. The January 1923 occupation of the Ruhr by Belgian and French troops seeking to secure reparation payments in goods – since the Mark was nearly worthless - was the final straw. German production was lost as workers employed a passive resistance response, and money was printed by the Weimar government to continue to pay workers despite their production halt. Within months, the German monetary system collapsed.

But think carefully about the causality here – it was not a normal situation at all where a sovereign government was trying to finance the saving desire of the non-government sector and keep employment and output levels high.

The other alternative is even less pleasant to contemplate, which is that there might be some Machiavellian genius behind the German position: perhaps their goal is to see the rest of Europe economically deflated into the ground, at which point, they will scoop up the pieces on the cheap, bit by bit. So Germany's motives are either misguided, or more sinister than is now apparent.

As a lasting, credible first step to offset the Eurozone's inherent structural flaws, its policy makers must first deal with the core issue, which is the solvency issue. After that, everything else falls into place. It will not restart economic growth, but it will get most of the EMU nations (Greece, perhaps being a conspicuous exception) out of the fiscal straitjacket because once the markets are persuaded that the individual countries are fundamentally solvent. The markets will lend again at sensible interest rates, which in turn can help to deal with today's problem of insufficient aggregate demand.. And this means the banks and markets do not have to worry about massive haircuts on the debt; the bonds are trading at distressed levels precisely because the markets do not believe these countries have a credible solution for the problem of national solvency.

The revenue sharing proposal which was proposed in last month's paper is the most operationally efficient manner to involve the ECB, with a minimum of legal disruption. Additionally, it is not inflationary, as it mere substitutes national bonds with reserves in the banking system and building banking reserves is not inflationary, as the BIS and NY Fed have both acknowledged.

But that is not on the cards right now. Still a primary role for the ECB is essential. To quote Professor de Grauwe again:

> There is no sillier way to implement a bond purchase programme than the ECB way. By making it clear from the beginning that it does not trust its own programme, the ECB guaranteed its failure. By signalling that it distrusted the bonds it was buying, it also signalled to investors that they should distrust these too.
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> Surely once the ECB decided to buy government bonds, there was a better way to run the programme. The ECB should have announced that it was fully committed to using all its firepower to buy government bonds and that it would not allow the bond prices to drop below a given level. In doing so, it would create confidence. Investors know that the ECB has superior firepower, and when they get convinced that the ECB will not hesitate to use it, they will be holding on to their bonds. The beauty of this result is that the ECB won't have to buy many bonds.

Well, if the ECB continues to operate from the perspective of Weimar phobia and disregards its equally important role as lender of last resort, then the Eurozone does not have much of a future. The central bank will continue to snatch defeat from the jaws of victory and the entire currency union will continue to bump along, moving fitfully from crisis to crisis until all grasp the nettle. The Eurozone's policy makers insist that they have finally constructed a credible bazooka. Even if it were true (unlikely), it is one which remains pointed at the policy makers themselves.

In the words of Italy's greatest poet: "Lasciate ogne speranza, voi ch'intrate."*

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*Abandon hope all ye who enter here – Dante, *The Inferno*

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