

MARKETS INSIGHT

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# EFSF needs bigger bazooka to maximise its firepower

By Willem Buiter

The European Summit to save the euro has brought temporary and partial solutions to three immediate problems facing the EU. First, to restructure insolvent sovereigns (Greece, most likely Portugal, quite possibly Ireland). Second, to recapitalise the many European Union zombie banks. And third, to ring-fence those sovereigns that, although most likely solvent, are at risk of a market liquidity ambush.

The 50 per cent loss likely to be imposed on private creditors is not enough to restore Greece's sovereign to solvency. I expect that, ultimately, both private and official creditors (including the European Central Bank, but probably excluding the International Monetary Fund) will have to write off most of their Greek sovereign exposure. Likely future restructuring of the Portuguese sovereign was not addressed, nor was the likely need for further funding concessions for Ireland.

Bank recapitalisation worth around €106bn is likely to provide between a third and a quarter of what will ultimately be required to bring about a fully functional EU banking system. Public resources also have to be found to guarantee new issuance of senior unsecured bank debt.

Without that, the ECB will be the dominant source of short-term and long-term bank funding. As regards ring-fencing Spain and Italy, nothing has been achieved except to gain some time to achieve a proper solution. Evidence of this is Italy's 10-year borrowing cost, which, following the summit, exceeded 6 per cent – an unsustainable level.

Given existing commitments, unavoidable future commitments to the second Greek programme, and a limited amount of bank recapitalisation support, there is at most €300bn left of the €440bn loss absorption capacity of the European financial stability facility, the eurozone's bail-out fund. Through financial engineering, this can be spread thickly over a small amount of new debt issues by Italy and Spain, or thinly over a larger amount. The €1,000bn or larger figures bandied around by some assume that a 20 or 25 per cent first loss guarantee would reduce Italian and Spanish borrowing costs on new debt issues to sustainable levels. It will not.

The Special Purpose Investment Vehicles (SPIVs), funded by some combination of senior debt, subordinated debt and equity from the EFSF and other parties, would raise the total new sovereign financing that can be supported only if these other parties put in new money on better-than-market terms.

The IMF cannot do this. It only funds sovereigns, insists on preferred creditor status and never provides equity. China, other emerging market (EM) sovereigns and sovereign wealth funds are unlikely to invest in risky instruments unless they are properly compensated, either by being allowed to purchase real assets or through political concessions. Only if Europe fails to get its act together in the coming year and the global financial system is threatened with made-in-Europe ruin, would the IMF, the non-European OECD member states and the EMs put together emergency facilities.

Equity contributions to the SPIV could only be expected from non-eurozone EU member states (UK, Sweden and Denmark). It would be in their interest to pay something. But the amounts would be small.

Ultimately, either the EFSF's loss absorption capacity is raised to €2,500bn or €3,000bn, or the ECB will have to stand ready to intervene on a similar scale required to stop the Spanish and Italian sovereigns defaulting. The ECB has the wallet to do so. I estimate its non-inflationary loss absorption capacity, very conservatively, at around €3,000bn. Using the ECB would be opaque, quasi-fiscal, off-budget and off-balance-sheet for national Treasuries. Conditionality would be under the table. So the ECB solution will be adopted in the end.

The ECB can intervene in the secondary markets on any scale without requiring anyone's permission through its existing Securities Markets Programme. Better, however, to restrict interventions to the new issues or primary markets. This could be achieved by turning the EFSF into a bank or by creating a subsidiary with banking status.

The EFSF bank could repo (offer as collateral for loans) with the eurosystem the sovereign debt it purchases in the primary markets. The ECB would have to grant better-than-market-terms for these repos if it is to support a sufficient volume of Spanish and Italian sovereign debt purchases. Or the new EFSF could repo sovereign debt with commercial banks. If these commercial banks then repo that same sovereign debt with the eurosystem, again with the ECB offering better-than-market-terms, we would have a big bazooka.

The choice, sometime in 2012 or, at the latest, 2013, will be between a collapse of the euro area and large-scale quasi-fiscal abuse of the ECB.

Finally, because neither restructuring of insolvent sovereigns, nor recapitalisation of zombie banks, nor ring-fencing of those sovereigns that are mostly likely solvent but vulnerable to illiquidity ambushes have been addressed decisively and completely, tight financial conditions and intensifying fiscal austerity will contribute to a European recession in 2012 and possibly beyond.

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