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MARKETS INSIGHT

October 31, 2011 6:39 pm

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EFSF needs bigger bazooka to maximise its firepower

By Willem Buiter

Feedback?

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.

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[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

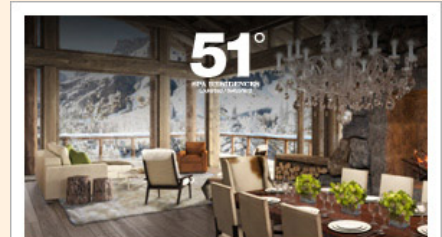
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instruments unless they are properly compensated, either by being allowed to purchase real assets or through political concessions. Only if Europe fails to get its act together in the coming year and the global financial system is threatened with made-in-Europe 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.

Willem Buiter is chief economist at Citigroup

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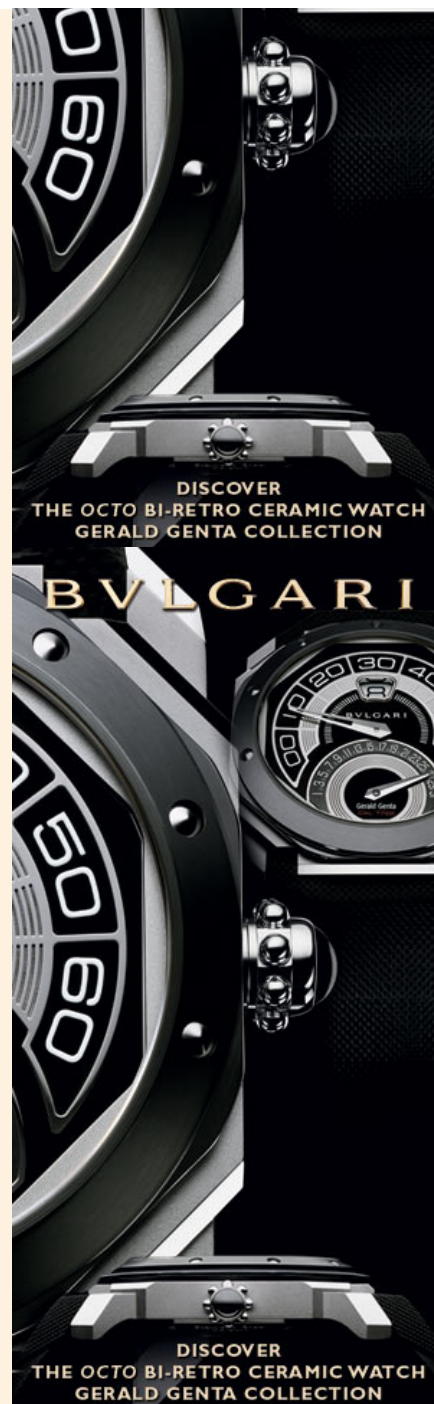
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J Richard | November 1 10:17pm | [Permalink](#)

[Report](#)

They eventually have to issue bonds with a partial gold backing. People have to have some assurance that they will get back some kind of asset that can't be inflated away to infinity. Throwing paper towards paper only fuels the fire.

Methinks there is allready something in the works. Too many ads and too many billboards wanting to



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meaning there is already existing in the world too many debt and too many empires waiting to buy gold. Someone, somewhere wants the gold.

bernhard otto | November 1 7:03pm | [Permalink](#)

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Bigger bazooka = Bigger debts

Bigger debts = states can continue to borrow to fund their bloated budgets = further financing of military activities is secured

Bigger debts = monetizing the debt = debasing the currency = inflation is rising and may get out of control

inflation = destruction of private capital (savings) = reducing the actual value of debts (capital borrowed to the state).

destruction of private capital = decreased investment in business activities = no job growth = tax revenues shrinking = increased borrowing by the states = go to the beginning.

This of course very simplified and not complete but it shows that the monetization of the debts is fueling a downward death spiral.

Times will be extreme tough anyhow for the average citizen in Europe and in the US. The mistakes made in past have now to be paid by the population the one way or the other.

Austerity measures and the abolishing of all of Wall Streets and the City's influence in politics would be like chemotherapy to treat the economic cancer the western economies are befallen with. It would be tough, extreme tough but it is the only hope left for the economical survival.

Debts and big bazookas, QE, operation twist and whatever other wonder cures offered are no cure. They are just morphium so that the dying becomes bearable.

Paul N. Goldschmidt | November 1 4:13pm | [Permalink](#)

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An excellent analysis pulling no punches.

It seems to me that this is the time to demonstrate to the market the political will to overcome the crisis. To do that there is a very simple and inexpensive measure to be implemented immediately: the merging of the IMF quotas of the 17 EMU Members into a single unit. If the Eurozone is not even capable of delivering this very rational move (One currency = one IMF Member) then it is hopeless to believe that it will be able to agree on a credible exit scenario for the crisis.

Such a move would certainly buy far more time than any number of Summits!

Coolman | November 1 2:03pm | [Permalink](#)

[Report](#)

Euro area = wont work. Greek referendum is another example of that pesky thing democracy getting in the way of peoples thoughts on solving the crisis. This crisis can not be solved for political reasons.

This is because people dont see themselves as european - even in germany. This whole thing is going to collapse.

Badger17 | November 1 12:53pm | [Permalink](#)

[Report](#)

Buiter argues that the ECB can take losses of 3 trillion. The ECB currently has a balance sheet of around 2 trillion with capital of around 400 billion. Oh what basis can the assumption be made that this balance sheet can more than double, while taking on losses of the order of 3 trillion? What will be the effect on the exchange rate?

Nick Antill | November 1 10:28am | [Permalink](#)

[Report](#)

Even this would leave the Eurozone looking like a much larger version of Italy: surpluses in the north funding deficits in the south, in perpetuity unless there were a radical realignment of costs and prices.

Bigtail | November 1 9:30am | [Permalink](#)

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The bazooka analogy is a very poor one. Debt dont dissappear. Increasing the debt further by leveraging and throwing good money after bad is only going to make things worse. The stagflation risks should not be taken lightly either. It is irresponsible to orchestrate this capital destruction only to postpone a debt reduction that will have to take place anyway.

When Mr Buiter suggests a transfer of a capital from European taxpayers to the banking sector it is simply not acceptable. This pattern of tax money transfer has to stop. Break up the banks into a risktaking part and a pure "meat and potatoe" part. Sure, this make life duller, as leverage goes down, but, rather than than risking a total financial collapse. As the situation looks right now, we are heading in the wrong direction.

Here are my suggestions;

- Let go of the Eur in its current form.

Focus on a core and a periphery. Germany may have to leave the Eur. That way, currency movements will at least realign with fundamentals, which will help in the necessary macro rebalancing act.

- Recapitalize or shut shop. This will mean most banks will end up in the hands of the state - for a while. Then relaunch the banking system with a clear split between risktaking part and basic banking part. Increase the risks for the owners to a level equal for "normal" corporates.

- Continue the EU work on harmonizing trade and employment in Europe.

This will be a costly lesson, but hopefully something to also build on for the future. It will in any case be cheaper than continue in the current direction. Just take the stop loss - now.

PAUL MYERS | November 1 8:24am | [Permalink](#)

[Report](#)

Please remember that in World War II, the American bazooka was a pretty poor anti-tank weapon. The best of the handheld anti-tank weapons was the German Panzerfaust.

Possibly the Euro will migrate over time to be a regional currency in Central Europe and France and other countries accepting German suzerainty in economic affairs.

Column right, march!

elizabeth schumann | November 1 7:21am | [Permalink](#)

[Report](#)

All of which being the wholly predictable result of politicians' euro hubris, into which they dragged us

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willy-nilly, kicking and screaming.

WendellMurray | November 1 12:31am | [Permalink](#)

[Report](#)

Unfortunately Prof. Buiter is wasting his talents, insight and honesty working for a big bank. No doubt the pay is good however and he can still live in London, but life is too short. He should be playing a key role as an advisor or decision-maker for the ECB or to Chancellor Merkel, where his knowledge and views could have decisive positive impact.

Richard Blair | November 1 12:29am | [Permalink](#)

[Report](#)

Forget about 3 trillion Euros and the ECB. A number of countries who presently use the Euro have no chance of being competitive with Germany in the foreseeable future.. The only way for the Euro to remain is for these uncompetitive countries to leave the system and go back to having their own currencies, which they can devalue. How bad does it have to get in Athens, Lisbon and Dublin before cold reality dawns ?

AK+ | October 31 10:00pm | [Permalink](#)

[Report](#)

It's a risky proposition.

Now we have a huge dollar amount in the financial system (outside of the real sector) looking for a return.

The author suggests complementing it with three trillion euros.

How will they "communicate" with each other? What happens if this enormous bubble bursts? Nobody understands these global financial processes thoroughly.

I'm afraid no one can manage it. Better and safer is to concentrate on the real economy in my view.

Clive Thompson | October 31 9:07pm | [Permalink](#)

[Report](#)

An excellent summary - as far as it goes.

I would suggest four further areas which might have been included for the sake of completeness - though at the risk of complicating matters for those Euro leaders who are BVLB (bears of very little brain). I would be very interested to know your thoughts on any or all of these.

Firstly, the need for full fiscal and political integration in the Eurozone - and the consequences of this for non-Eurozone members of the EU.

Secondly, the importance, at least in the medium term, of introducing Glass-Steagall on steroids to hive off 'trading desks' from banking.

Thirdly, the possible (admittedly hard to predict) role of politics and democracy. Two obvious examples - i. what happens if the Greek hoi polloi vote 'no thanks' in a referendum on their bailout?; and ii. how much might matters be improved if Berlusconi were to go?

And fourthly, the likely impact of an immediate and sharp reduction in short-term rates by the ECB?

Kind regards
Clive.

Augustino11 | October 31 8:57pm | [Permalink](#)

[Report](#)

There is another bazooka which is the EU's budget which is barely 1,000 bio over 5 years.

Tripling that, with a combination of tariffs, new taxes and federal bonds (issued on the Commission's name, not the eurozone or EU states') and using it to federalize large swaths of national policies (energy, transport, pensions, health insurance, etc) or at least to offer a "federal" backstop to national policies that would simultaneously be cut back to reduce debt, all that could also do the trick. And if this could all be done after having sacked the useless Barroso and the useless van Rompoy and held one big european parliamentary election, with a commitment of member states to let the EU parliament decide by itself on the Commission's president and its members, then all the better.

I don't see the British refusing large money transfers from Brussels out of "pride", but these days you never know.

peter astbury | October 31 7:40pm | [Permalink](#)

[Report](#)

Seems that markets like leadership and parameters after all