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'Free insurance' alternative has no stigma

By Michael Heise

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Despite the relief in markets after the EU summit, yields in Spain and Italy are still dangerously high. Current levels are neither compatible with long-term fiscal sustainability nor appropriate for economies teetering on the brink of deep recession. The chorus clamouring for bond purchases by the European Central Bank or through the now relaxed procedures of the European Stability Mechanism, the bailout fund, will remain loud. After all, buying long-term government bonds – quantitative easing in the jargon – is a proven monetary tool of the US and other central banks. What is good for the US surely can't be bad for the eurozone, can it?

Some careful economic analysis is required. The Securities Market Programme of the ECB was aimed at restoring an appropriate monetary transmission mechanism but also intended to address the malfunctioning of government bond markets, in other words to render state financing less burdensome for countries with limited access to financial markets. But this is a mixed blessing: If lower interest rates are seen by governments as an invitation to relax on the speed and intensity of reforms and fiscal consolidation, it would only undermine long-term fiscal sustainability. The ECB could easily be dragged into an infinite rescue operation. Further, monetary stimulus for the economy can hardly be expected as long as the main cause for the credit crunch in peripheral countries is not addressed.

The same logic applies if, instead of the ECB, the ESM were to conduct the purchasing. Last Friday's summit has actually reduced the hurdles for such bond purchases by making them less contingent on a country's commitment to adjustment and reform measures. Such an approach may score better than direct ECB purchases in terms of democratic legitimacy, as the ESM is effectively controlled by national finance ministries. But it faces an additional problem of inadequate firepower. The combined outstanding government debt of Italy and Spain alone amounts to roughly €2.6tn; this is almost four times the combined capacity of the European Financial Stability Facility and the ESM, the twin bailout funds. Large-scale purchases to cap interest rates for these countries would soon deplete the funds, calls to top up the firewalls still further would be inevitable. That would create grave risks for the euro as the willingness to put yet more taxpayer money at stake is already minimal.

So how can policy makers stimulate the return of growth and capital to peripheral markets? A clear assignment of roles and responsibilities is required. Monetary policy should focus on maintaining the conditions for growth – that is to avert a credit crunch. With inter-bank markets in tatters, the ECB has no other choice but to refinance peripheral banks directly. The two longer-term refinancing operations (LTROs) and the loosening of collateral requirements were aimed at achieving just that. If necessary, the ECB should do more of the same, especially since it soon will be involved directly in banking supervision and will have more powers concerning the solvency of banks it lends to.

The underlying task, however, is to restore confidence so that money markets are reset and capital flows back to peripheral markets. To this end, structural reforms and fiscal discipline are indispensable. But they do not work quickly and therefore need to be accompanied by

measures to reduce borrowing costs. Debt-stricken countries need to take advantage of the instruments that are ready to use in the EFSF and later also in the ESM: A partial risk protection on new bond issues. By guaranteeing for example the first-loss tranche of, say, 30 per cent, risk-return profiles of government bonds are considerably improved, risk premiums should at least be halved. Investors, not least banks, would be incentivised to buy such bonds. This “insurance option” seems to be tailor-made for the present predicament in Spain and Italy – it would reduce yields without imposing additional costs and fiscal strains on the countries, nor would it entail a punitive Troika-led adjustment programme but would be underpinned by commitments made within the fiscal compact and the stability and growth pact. The argument that resorting to this free insurance option may carry a stigma in financial markets is no longer convincing as the countries themselves are dramatically highlighting the dangers of limited market access and appealing for support.

Rather than constantly conjuring up new instruments, it would make sense to deploy those already created at previous summits. The sovereign bond protection facility, together with an expansionary ECB policy and an enhanced supervisory role for the ECB, would form a credible and cohesive action plan to stabilise peripheral economies in the short term. Such plans are merely stopgaps, buying time for the necessary economic policy reforms and for progress towards more political and fiscal integration. Last week’s summit was a crucial step on the long road forward. More crucial summits will follow.

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