Miroslav Singer: Sovereign debt crisis in Europe – assessing the current European instruments – addressing the challenges ahead

Speech by Mr Miroslav Singer, Governor of the Czech National Bank, at the European Parliament Committee on Economic and Monetary Affairs Public Hearing, Brussels, 23 January 2012.

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Members of the European Parliament,

Thank you for inviting me to this forum and giving me this opportunity to comment on the European Financial Stability Facility (EFSF). The last few weeks have brought us three new events that are rightly or wrongly regarded as game changers and I would like to discuss the EFSF in the context of those events. They are: 1) the ECB's long-term loans to commercial banks and the widening of the range of guarantees which the ECB accepts from commercial banks for them, 2) the fiscal pact and 3) the rating downgrades. I would like start by saying that the provision of liquidity to commercial banks in Europe by the ECB gives us time to define more precisely the mission, design and operation of the Facility as well its position among the institutions charged with resolving the debt crisis. If we want to reduce the probability that some European nations and their banking groups will face liquidity problems that they cannot solve by obtaining funds from the market, we need to eliminate the following uncertainties relating to the EFSF:

1. It is not clear what benefits we expect from the EFSF or how it is supposed to generate them. Many objectives have been hinted at in the more than 18 months since it was created, but nothing specific has been implemented so far. Yet each of the objectives is highly important, be it the issuing of protection certificates or the establishment of the special purpose vehicle or the purchasing of peripheral countries' bonds in the secondary market.
2. The ambiguity in the definition of the Facility's mission is indicated by the changes made both to its guarantee structure, even though the structure remains based on the "per partes" principle, and to its rules of operation during its short lifetime. The fact that the term EFSF 2 has caught on for the new structure reveals just how fundamental these changes are seen to be.
3. Uncertainty also exists on the issue of increasing the effective capital strength of the Facility using concepts such as leverage (via an SPV), protection/insurance, loss tranches and short-term funds. From the reputational perspective, these are exceptionally controversial issues, because many market participants interpret them as a mere attempt to disguise the fact that the euro area countries do not currently have enough resources for a credible rescue plan for Italy and Spain. If they did want to create such resources, they would be putting their own debt arithmetic at risk, because under Eurostat methodology the guarantees for the EFSF's bonds are included in the guarantors' gross government debt. If the Facility is to provide effective assistance in stabilising the larger European economies, it will need more funding. Each of the concepts poses a serious threat to the reputation and credibility of the Facility.
    a. Excessive leverage is now regarded as one of the causes of the financial crisis.
    b. The proposals for protection and a first loss tranche of 20% of the nominal debt are also laden with problems. The example of Greece demonstrates that the losses may run to 60%. There is great uncertainty about who would pay for the difference between the insured loss and the actual loss if the Greek

scenario was to be repeated in other countries. Likewise, it is not clear how freely tradable protection certificates would be traded, priced, settled and, in the event of default, enforced if they were to be introduced. Such certificates would de facto be quasi CDS instruments underwritten by the official institution of a community of countries that are simultaneously waging a campaign against credit derivatives because they regard them as one of the causes of the crisis.

c. The signs of a gradual shift towards short-term funding of the EFSF are a worrying signal. The risk arising from financing assets that are by definition long-term and illiquid (primarily rescue loans) through a programme of short-term debt instruments (liability rollover risk) is more than clear. This ALM model proved to be extremely risky during the financial crisis when the commercial paper market dried up.

4. Another uncertainty is related to the project of purchasing bonds in the secondary market. To fund these purchases, private capital will be needed (e.g. in the form of senior tranches of SPV debt). Therefore, this project lacks the firm official commitment which similar central bank (BoE, Fed) programmes not reliant on private investor participation have.

5. The latest uncertainty is the adjustment of the entire EFSF project to the loss of France's (and Austria's) AAA rating from S&P, followed by the downgrading of the EFSF's own rating from AAA to AA+. In its comments on this change, S&P stated explicitly that the EFSF's rating has a developing outlook, which means that the agency foresees the possibility both of returning the rating to AAA (if offsetting credit enhancements are adopted) and of downgrading it further to below AA+ (if key guarantor countries are downgraded). A lower EFSF rating would probably be associated with higher interest costs of refinancing. There might even be a fall in liquidity in the EFSF bond market owing to the exit of some institutional investors, who primarily target the AAA segment of issuers.

6. On a more general level, the lack of coordination of resources for supporting European countries is disturbing. It is resulting in fragmentation of resources and a lack of transparency in the setting of parameters such as "who", "how much", "to whom" and "how". Specifically, the European Union, or the euro area, is planning simultaneously to lend to the International Monetary Fund, to guarantee the EFSF and to guarantee the ESM, while central banks guarantee the capital of the ECB. If a non-European country wanted to help Europe, there is the question of whether it should send the money to the IMF or use it to purchase EFSF bonds, a senior tranche of the SPV, or the peripheral countries' debt, i.e. with no intermediation.

The many uncertainties associated with the specific operation of the EFSF are giving rise to general doubts about the appropriateness of the current approaches to overcoming the ongoing debt crisis in the euro area. I cannot help feeling that many solutions to the problems have been wrongly chosen in part because the main causes of the financial and debt crisis have not been correctly identified.

Greece gets too much attention from decision- and policy-makers. It represents a mere 1/50 of the European economy. I believe that without the political will to provide Greece with massive support from European funds to restore its competitiveness – and I see little such will at the moment – its exit from the euro area will be inevitable, since depreciation of the Greek currency will become part of the measures to restore competitiveness. The provision of loans to Greece has so far primarily bought time. This has enabled wealthier Greeks to transfer their savings out of the country. The costs of such action have been a reduction in Europe's credibility and harm to the reputation of the International Monetary Fund and its ability to raise funds outside Europe. I am therefore very glad that this session is devoted to the Facility, whose importance to Europe and especially to the euro area is much greater.

I could list other problems, such as the delayed consolidation of the European banking system and the related recapitalisation of banks, and in particular the fact that the existence of the euro area has widened the long growing imbalance in the exchange of goods, capital and savings between euro area countries. The short-term rescue of the euro will not directly solve the long-term problem of imbalances, and in particular the gradually emerging path towards a fiscal pact with no significant redistribution of resources at European level will require the elimination of, or at least a considerable reduction in, the imbalances in the euro area.

In the context of the three change drivers I mentioned earlier, I would like to say that the time that the ECB's pre-Christmas actions gave the euro area, the European financial sector and many European states to solve their problems is useful but not infinite. I believe that the potential of the fiscal pact to become a true change driver is smaller than generally assumed, and I expect that the future formulation of the pact in the constitution of each country will contain (abusable) escape clauses. I base this view in particular on the fact that throughout its existence the euro area has had a tendency to soften or bend the criteria for its operation. Be it the not-always-proper manner of fulfilment of the Maastricht criteria by accession countries or the revision of the Stability and Growth Pact or the purchase of government bonds by the European Central Bank, we have repeatedly seen how things that are initially unthinkable become reality over time. I am doubtful that investors, who are well aware of Europe's relationship to the rules, will change their attitude as a result of the fiscal pact.

My overall view on the current design of the Facility is none too optimistic. To enhance its ability to face the debt crisis, we need to find a clear consensus on its mission. We need to precisely identify whom it is supposed to help, under what circumstances and to what extent, and to derive from that the amount of funding it needs. This will predetermine the solutions to all the issues surrounding its operation. We have time to solve all these problems, but not much time.

Thank you for listening.