Aloys Prinz and Hanno Beck

Fighting Debt Explosion in the European Sovereign Debt Crisis

Eurobonds, Leveraging EFSF and Euro-TARP

A number of tools have been suggested for solving the European sovereign debt crisis, in particular the options of leveraging the EFSF/ESM, introducing Eurobonds and a European Troubled Asset Relief Programme (Euro-TARP). However, it is unclear how these instruments will work, given jittery financial markets, the pending sovereign default of Greece and the fear of contagion among other countries. In the following paper, these policy tools will be analysed and evaluated with respect to their effects as well as their potential power to solve the debt crisis.

The severe sovereign debt crisis in the eurozone has been immune so far to all of the measures that have been taken to solve it. It has become obvious that the eurozone lacks a mechanism to solve such a crisis, primarily because it was not considered possible that a eurozone country could come to the brink of sovereign default. The aftermath of the 2007 world financial crisis also proved that highly developed countries were not completely protected from default. Jittery financial markets expecting a bailout of eurozone member countries were further disturbed by a sudden change in the political inclination of eurozone leaders, who started to demand contributions from private investors for a solution to the crisis. This sudden change of mind may be taken as the turning point, after which panic in financial markets took over. When the debt crisis began in Greece, there was a real opportunity to avoid anxiety as well as contagion by simply accepting an orderly Greek default along with rescuing endangered banks, accepting spreading interest rates for sovereign public debt according to default risks, and recapitalising European banks. Although this policy would also have triggered a kind of panic, it might have solved a crisis which since then has only expanded.

Meanwhile, there is no silver bullet on the horizon which could solve the crisis at once. Moreover, if the ECB had not bought the sovereign debt of endangered countries in the secondary market, the euro might already have disappeared. Since no other institution was available, the ECB was not only the lender of last resort for eurozone banks but also for (nearly) defaulting countries. In this way, the ECB was taken in tow by fiscal policy, in violation of its statute. To end this unbearable situation, the European Financial Stability Facility (EFSF) was agreed upon – but not immediately ratified – by the euro countries. The temporary EFSF is to become permanent and will then be known as the European Stability Mechanism (ESM). However, these policies have also been unable to solve the crisis so far.

The main explanation offered by critics for the ineffectiveness of the EFSF/ESM announcement was the lack of financial firepower. Critics suggested the EFSF/ESM ought to be leveraged to increase its financial capability. For example, the EFSF/ESM could be used as a bank, rather than a mechanism, to buy sovereign debt securities and utilise these securities as collateral for central bank money from the ECB. In this way, EFSF capital could be multiplied.

Eurobonds were proposed as a second way to guarantee that no eurozone member country would ever risk a default. Since these bonds would be guaranteed by all mem-


Aloys Prinz, Institute of Public Economics, University of Münster, Germany.

Hanno Beck, Pforzheim University Business School, Germany.
Debt Crisis

...ber countries, no single country could be attacked by the financial markets. To mitigate the inherent moral hazard problem with Eurobonds, eurozone countries would have to relinquish a portion of their national sovereignty with regard to their public budgets.

A third proposal to end the European sovereign debt crisis consists of a Euro-TARP, designed after the US programme to save banks from bankruptcy in the post-Lehman crisis. So-called troubled assets, i.e. non-performing public debt, would be bought by the TARP institution to clear endangered banks’ balance sheets.

In this paper, the likely effects of these policy tools are analysed. The question is whether one of these policies might actually provide a solution to the European sovereign debt crisis. The remainder of the paper is structured as follows: first, the bond-buying programme of the ECB is investigated. We then scrutinise Eurobonds and EFSF/ESM leveraging before turning our attention to the Euro-TARP proposal.

**ECB Debt Financing**

It might be that the European sovereign debt crisis would not have occurred without the global financial crisis of 2007-08, or at least it would not have happened at this time with such intensity. Be that as it may, it has happened as follows. The financial crisis forced most European states to spend a lot of money to save their banking systems. Thereafter, some of these countries found themselves confronted with very high budget deficits and sharply increasing levels of public debt. Moreover, and probably even more importantly, the expectations for economic growth were bleak. At this point the financial crisis jumped from the banking system to the states themselves, because some of them appeared no longer able to serve their sovereign debts. As a consequence, private investors, especially banks, became very reluctant to lend money to certain European states. Hence, the interest rates at which they could borrow money increased to levels where it was even more unlikely that they could serve and repay their newly emitted debt securities. As soon as it became clear that some countries might be unable to stay solvent, banks became reluctant to lend central bank money to one another on the interbank money market, obliging the ECB to assume the role of lender of last resort. But this did not solve the financing problems of the GIIPS countries, who could not get the new loans they required at affordable interest rates. To calm markets and to prevent countries from defaulting, the ECB started a bond-buying programme for the GIIPS countries.

3 See P. De Grauwe, op. cit.
4 Greece, Italy, Ireland, Portugal and Spain.

**Figure 1**

**Debt Explosion I: ECB Debt Financing**

The consequences of the ECB financing of the public debt of GIIPS countries are shown in Figure 1. In this figure, the central players are the banks, which invest in the debt securities (debt sec.) of national states, the ECB, which provides central bank money (CB-money), and two groups of states – GIIPS countries and non-GIIPS countries. The securities of non-GIIPS countries are called “debt sec. I”; the securities of GIIPS countries are “debt sec. II”. Moreover, it is assumed that banks no longer provide loans to GIIPS countries (the flows between banks and GIIPS countries are zero, as depicted). For sake of simplicity, the ECB is assumed to lend directly to the latter country group, i.e. the ECB transfers central bank money for debt securities II directly to those countries.

Imagine now that the ECB stopped buying GIIPS debt in order to limit the risks to its own balance sheet. At this point the crisis would immediately start again, because the private financial market would have no incentive to lend to GIIPS countries since nothing would have changed concerning the structural problems of these countries. It would seem, therefore, that the GIIPS countries would force the ECB to finance all maturing and newly emitted debt. This would constitute a positive feedback loop, as indicated on the right-hand side in Figure 1. The process would end with all debt securities II on the ECB’s balance sheet. A consequence of this would be financial losses for the ECB. Since the eurozone member countries are the owners of the ECB, they would have to bear these losses. The ECB could pay a lower profit to the budgets of the owner countries, and with further increasing sovereign non-performing debt securities on the ECB’s balance sheet, the central bank’s capital and reserves would have to be replenished by taxpayers’ money. In this way, the GIIPS countries’ debt may become completely socialised via a positive feedback loop, as indicated on the left-hand side of Figure 1. We refer to this process as debt explosion, which will occur if the ECB is completely taken in tow by the fiscal policy of the GIIPS countries. Without rules that enforce sovereign default at