THE GROWTH DIALOGUE

SEPTEMBER 2011
NUMBER 1

POLICY BRIEF

The Euro-Zone: Slow Growth, High Debt and Pressures on Banks and Official Financial Institutions

*James A. Hanson**

Overview

The risk of continued slow growth and even a double dip recession is high in the Euro-zone. The slow growth reflects continued although often incomplete austerity programs to ease sovereign debt problems; the lack of fundamental structural reforms in these programs; and the market's recognition of these half-hearted attempts. Lack of fiscal space, exacerbated by the recent financial crisis as well as the increased cost of borrowing, limits the possibility of fiscal stimulus, and euro membership removes either the exchange rate or monetary as policy instruments. The pattern of slow growth is not unusual for highly indebted countries (Reinhart and Rogoff, 2010), although it is made worse by euro membership. Given the pessimistic outlook, the private sector is unlikely invest much, thereby contributing to the slow growth and intransigently high debt-to-GDP ratios.

Financial-sector issues in the Euro-zone interact with these problems. Banks remain weak in many cases, as reflected in equity markets and recently noted by the IMF. In the future banks may face capital problems from increasingly weak loans and losses from partial defaults on sovereign debt; there are already signs of liquidity issues. In response, banks are limiting their lending, which contributes to the slow growth and raises new concerns and the risk of bailouts.

These developments mean that the European Central Bank (ECB) and the national central banks are likely to face pressures to provide support to weak banks and buy sovereign debt over the next 12 months. The ECB's role as lender of last resort has been stretched to the limit. Faced with continued political resistance to debt write-downs, however, pressures will persist and present chal-

*Former Senior Financial Advisor, World Bank. Send comments to jhansonecon@yahoo.com, copied to info@growthdialogue.org

lenges both to the ECB as well as to the Euro-zone itself.

Growth, Fiscal and Sovereign Debt Problems

Euro-zone countries face a significant risk of continued slow growth or even a double-dip recession. In many countries, GDP growth has slowed or even declined during the last year; even Germany appears to have slowed down in the most recent data. Only Germany, like the United States, has roughly returned to its 2007 GDP. Fiscal stimulus is impossible for many countries given their lack of fiscal space, which reflects both the 2008–09 financial crisis and structural fiscal deficits, particularly during slow growth periods. Some countries have become overvalued under the fixed euro exchange rate and lost export shares even within the Euro-zone. Other countries have proposed or started fiscal austerity measures to reduce the problems associated with financing their high debt-to-GDP ratios and fiscal deficits. However, concerns have been raised that austerity programs without significant structural reforms will lead to still slower GDP and employment growth and less tax revenue, and as a result the programs may not affect the fiscal deficit or debt-to-GDP ratios much.

Limited progress on the austerity programs has occurred in some cases. Regarding Italy, for example, European leaders have expressed concern over the slow progress of a significant austerity program in the Italian parliament. Portugal, which received a support program from the European Union (EU) and the International Monetary Fund (IMF) in 2010, is proposing new fiscal austerity measures.

The Greek program has been the most important concern. The 2010 support program from the EU and the IMF has proved insufficient. At end-July 2011, a preliminary agreement was reached on a second Greek bailout, to be finalized and then presented for national parliaments' approval. The preliminary-agreed bailout involved a) the IMF; b) the EU; c) the European Financial Stability Facility (EFSF), which pending parliamentary approval will have the authority to provide loans to Euro-zone banks and/or buy sovereign debt directly or in the market); and d) a reduction of Greece's obligations to holders of its debt, similar to the Brady Plan but without its guarantees.

Various complications have arisen since July, however. Some countries (for example, Finland, the Netherlands, and Austria) have inquired about collateral for their contribution and Greece is seeking 90 percent participation in the debt relief part of the plan. Such a level of participation would mean losses to the German government-owned "bad banks" for two German weak banks that had held substantial Greek debt. Greece is also showing reluctance to sell shares of publicly owned enterprises in its depressed stock market and its fiscal performance continues to be worse than projected in program negotiations. On September 2, 2011, officials negotiating the final package left Greece for 10 days. More generally, concerns continue to exist that Greece will be unable to carry out the terms of the new program; that the program would be too small; and, based on this experience, that any future bailouts of larger countries would require a much larger EFSF and more funds in general, which would certainly face major resistance in the current political environment in many Euro-zone countries.

Debt and Banking Sector Issues

The countries' austerity programs are motivated by the problems in rolling over the high levels of sovereign debt and financing large fiscal deficits. The fiscal deficit, not the primary deficit, is important, because the primary deficit adjusts for interest payments, in effect assuming a rollover can be made. The critical fiscal issue, particularly in a period leading up to a possible crisis when interest rates are much higher than nominal growth and rollovers are difficult, is financing the fiscal deficit *including* interest payments.

A further major debt issue in the Euro-zone is that national treasuries sell bonds denominated in euros, a currency they do not issue. Like non-U.S. countries selling dollar-denominated bonds, Euro-zone countries cannot guarantee that they will have sufficient liquidity to pay interest and maturing bonds, without debt rollovers or Euro-zone support. Unexpected domestic inflation, recommended by some, does not help reduce a Euro-zone country's debt burden, because the debt is fixed in euros. The overindebted countries either need to a) roll over outstanding bonds in the markets; or, b) if market and bank demand for the bonds is lacking, receive support from official Euro-zone financial institutions; or c) default. Default would cause major problems throughout the Euro-zone because of the importance of multicountry banks, not to mention the holdings of these national debts by the ECB and the national central banks.

European banks of course suffered during the 2008–09 financial crisis and received government support; some were closed. The surviving banks have been rebuilding capital and, not surprisingly given the slow recovery, limiting lending. The slowdown in lending, in turn, has limited growth. In this environment, banks had incentives to hold government debt because of its zero risk weight in calculating required ratios of capital to risk. Weighted assets meant less capital had to be accumulated.

Currently, capital issues have nonetheless reemerged in some banks and liquidity seems to be an increasing issue. The IMF recently raised the issue of low capital in Euro-zone banks. Recent stress tests by the EBA did suggest that less than 10 percent of the sampled banks, five of which were in Spain and two in Greece, would fall below the minimum capital adequacy in the event of a shock. All major banks were calculated to exceed the minimum capital under stresses posed in the test, although some were close to the minimum. However, the tests may have understated the exposure to a sovereign default, particularly default by the home countries of smaller banks. The International Accounting Standards Board has raised that issue recently by calling into question some banks' provisions for losses on debts of governments, not just in Greece. This issue is particularly relevant given the precedent for requiring sovereign debt holders to accept losses in the second Greek bailout.

Liquidity is also an issue because large European banks tend to depend more on short-term and interbank funding than large U.S. banks. Various estimates (for example, from Morgan Stanley and the European Banking Authority (EBA) Stress Test) suggest that nearly half of their current funding would need to be rolled over in the next 12 months. Although interbank markets do exist, banks tend to shun loans to banks that appear weak and cannot be counted on for funding. Moreover, U.S. money market funds have recently reduced their exposure to European banks. Hence, funding for banks and, correspondingly, bank lending may be slowed further, curtailing GDP growth. Banks' ability to finance increased purchases of government debt may even be limited. These liquidity issues suggest that there may be need for funding support from Euro-zone financial institutions and, for failing banks, takeovers with government funding.

Funding from Official Financial Institutions

In general, central banks' funding to banks is often titled *lender of last resort* support, although it often does not meet Bagehot's classic policy (1873) for lenders of last resort: lend at a penalty rate to solvent but illiquid banks that have adequate collateral. Nor does central bank funding meet the implicit policy for insolvent banks of prompt injection of capital or closure, with a deposit insurance payoff, if it exists, and liquidation by bank resolution facilities if necessary. Judging whether a bank is solvent or not depends on the quality of accounting and involves issues regarding the time horizon over which and the asset prices at which a bank is judged solvent. In practice, lenders of last resort have often charged non-penalty rates, eased their collateral requirements, and have been used to avoid prompt bank closures.

There are also some general problems with the existence of a centralized lender of last resort. It may encourage banks to minimize their liquid asset holdings and rely on market finance, particularly if lender of last resort rates are low and collateral requirements are weak—a moral hazard created by the existence of a lender of last resort. Finally, in open economies, lender of last resort loans may fuel a run on the currency, as occurred in the East Asia crisis of 1997. Such problems of the lenders of last resort, and lack of prompt intervention for and resolution of weak banks, have proved costly and contributed substantially to debt buildups in both developing and industrial countries.

In the EU initially, the lender of last resort function was decentralized and based on national central banks, deposit insurance, and treasuries in a reflection of the EU's national fiscal responsibility rules. The ECB focused on monetary policy. Integration of the impact of the national lenders of last resort on Euro-zone monetary policy was addressed and coordination developed on information and liquidity issues across the national central banks. (*Schinasi and Teixeira, 2006, discuss these developments and issues.).* Not surprisingly, however, decentralization still faces information and coordination issues, especially with banks' expansion across the EU. This expansion also raises the issue of which national bank/deposit insurance/treasury should act as the lender of last resort and recapitalize a bank with subsidiaries across the EU.

In the 2008 crisis, the ECB went beyond its monetary policy focus by offering major support as lender of last resort, although this support was still much less than the U.S Federal Reserve's support of $1.2 trillion (maximum) outstanding in December 2008. Interestingly, the Federal Reserve (Fed) played a major role in support for European banks. Almost half of the Fed's top 30 borrowers were European banks, including the Royal Bank of Scotland, UBS, Belgium's Dexia SA, Societe Generale, Rabobank, and Germany's Hypo Real Estate Holding AG and Commerzbank (see various Bloomberg presentations). The European banks' U.S. subsidiaries were often, but not always, the borrowers—some borrowing banks had a minor presence in the United States. Another factor in European banks' borrowing was the Fed's substantial easing of its lending rates and collateral quality requirements. Thus, the demand for funds probably reflected both a demand for dollars and the Fed's easier terms compared to the ECB's.

In 2010–11, the ECB has continued a version of its lender of last resort support. The ECB made loans to banks based on collateral of debt from Ireland, Greece, and, to a lesser extent, Portugal, Spain, and Italy. This collateral was accepted even though the Greek debt in particular had dropped substantially below AAA ratings, exposing the ECB to risk in the event of a default. These ECB's loans were often, but not always, to banks from the same country as the collateral. In some cases large banks from other countries, notably France and Germany, continued to hold debt from other governments despite the fall in its price, to avoid a sale that would show a loss. Other lender of last resort funds came from the national central banks in the southern tier of the Euro-zone, which in effect have been extending credit by running up payments deficits with the northern-tier central banks (*The Economist*, 2011).

Recently, demands by banks for support have been growing and actions are being taken to support weak banks rather than close them, as is often the case with lender of last resort facilities. Since the July preliminary agreement on Greece, requests for ECB lender of last resort support have grown. One bank recently borrowed some $500 million from an ECB facility that had not been used in the past six months. The ECB has also authorized national central banks to lend to domestic banks when they run out of "EDB eligible capital." In Greece, the worst-hit country in the sovereign debt crisis, deposits have fallen substantially. Recently, Proton, a small, failing bank, received a €100 million transfer from the government, was intervened by the central bank, and was recapitalized by the four largest Greek banks to help avoid a run on the Greek banking system. One of these four banks received €3 billion support from the central bank and merged with another, with new capital funds for the merged bank of €500 million from Qatar. The fourth largest bank received €2 billion from the Greek central bank.

Also, the ECB recently renewed its policy shift from a purely lender of last resort role to buying debt of European governments. In May ECB reopened its Securities Market Program (SMP), which had begun in May 2010 and had largely been used for Greek, Irish, and Portuguese debt. The SMP recently purchased over €30 billion of Spanish and Italian debt in an attempt to limit the rise in their interest rates owing to contagion from potential loss on Greek debt under the preliminary agreement on the second Greek bailout. The ECB purchases were in the secondary market—the ECB is prohibited from primary market purchases—and small relative to these countries' outstanding debt.

The ECB also undertook sterilization of the SMP's monetary impact. Nonetheless, these ECB purchases brought criticism, notably from the Bundesbank and the president of Germany. Thomas Mayer, economist for Deutsche Bank, and others have commented that such purchases have gotten the ECB into government financing, contrary to the intent of the Maastricht treaty.

More fundamentally, the Euro-zone countries and banks face the risk of sovereign default, if there is a lack of purchases of the euro-denominated bonds, as noted above. The EFSF was expected to ease this problem by replacing the ECB as a buyer of Euro-zone debt, but it is still awaiting finalization of the second Greek bailout. In any case, the EFSF is likely to be too small and cumbersome to intervene effectively in bond markets, particularly given the political obstacles to another sovereign bailout.

Conclusions

These and other developments suggest that the ECB's lender of last resort function, its overall role, and bank resolution in the Euro-zone will face major demands and challenges over the next few months. European banks, which have relied more on market-based, short-term funding than U.S. banks, are expected to require substantial rollovers of their funding in the next 12 months. However, U.S. money market funds are selling off European banks' debt, not buying. And the Fed, which is already examining the European bank subsidiaries' access to funds, may not wish to play a large lender of last resort role to European banks again.

The ECB is already supplying increasing liquidity to EU banks, as noted, as are national central banks in the countries with the weakest sovereign debt. More generally, some European banks could use more capital. And banks' provisions for losses on sovereign debt, not just in Greece, are often low, according to the International Accounting Standards Board.

In this context, and given the political opposition to further bailouts in the Euro-zone, the Zone's lenders of last resort are likely to be called upon increasingly. They would face risks of supporting insolvent banks because of information problems, which would affect their capital, as well as questions of who should support multicountry banks. There is also a question of whether such activities can be done on a large scale when fully sterilized, since sterilization will tighten credit in the already-slowing northern Euro-zone tier. In this context, full sterilization to avoid monetary expansion from the support to banks and inflation would be premature.

The ECB's role in supporting government bonds, although thus far small, is likely to face challenges, politically and economically, if national crises develop beyond Greece and bailouts continue to face major political opposition in the EU. As a result, the ECB is likely to limit its purchases of government bonds in the near future. This policy may contribute to higher rates on countries' sovereign debts and, along with their slowing economies, increase fiscal problems. And, in the event the second Greek bailout falls through and/or other crises occur, the ECB seems unlikely to be ready to increase promptly and substantially its support. The role of the ESFS faces similar and more difficult issues. Addressing these problems is complicated by the more general issues of fundamental political differences over bailouts and macroeconomic policy within the Euro-zone. These differences limit the Euro-zone's ability to respond promptly to crises and raise deeper questions of its very unity and its single currency.

References

Economist, The. 2011. "How Much Financial Risk Has the ECB Taken On as a Result of the Euro Debt Crisis?" June 9.

Reinhart, Carmen, and Kenneth Rogoff. 2010. "Growth in the Time of Debt." *American Economic Review* (May): 573–578.

Schinasi, Garry, and Pedro Gustavo Teixeira. 2006. "The Lender of Last Resort in the European Single Financial Market." IMF Working Paper WP/06/127. IMF, Washington DC.