Wolfgang Münchau

Associate Editor Financial Times and
President of Eurointelligence

How Much Risk Can a Central Bank Assume?

I will not answer this question because it is essentially unanswerable in abstract. The more relevant question for us today is whether the European System of Central Banks (ESCB) is taking on too much risk by accepting lower standards of collateral than before, and by purchasing sovereign European bonds in the secondary markets.

The question is complicated because the answer necessitates assumptions about future political decisions. For example, would the European Union be prepared to extend the European Financial Stabilisation Facility (EFSF) beyond its currently envisaged three-year term? Would it turn the EFSF into a proper institution of the euro area? How will the political system deal with a potential default of a Member State, or the imposition of a haircut? The risks for the central bank obviously very much depend on the willingness of a Member State to share the risks. If you take the European Treaties literally, especially Article 125 of the Treaty on the Function of the European Union (TFEU), the famous "No Bailout clause", it would be a prudent decision not to assume too much in terms of political risk sharing beyond the measures agreed so far. While it is impossible to predict how governments will behave if a Member State were to default, it would be prudent for a central bank to base its action on a conservative view about government behaviour, and to adopt a literal interpretation of Article 125 TFEU.

In other words, the risk management consideration should be based on the assumption that the ESCB itself should remain well capitalised.

In this essay I shall explore the riskiness of the bond purchase programme in view of the accompanying banking crisis. I shall not, however, present central bank recapitalisation scenarios. This would take us a scenario too far at this stage. It is best to focus on the inherent riskiness of the new policies themselves.

Greece: a Sovereign Debt Crisis

Let me start with some simple back of the envelope analysis of Greek debt sustainability. This will show that default – under any realistic political and social assumptions – must now be the most probable outcome despite the agreement in May 2010 with the EU and the International Monetary Fund (IMF) about a multi-annual fiscal and structural adjustment programme.

In 2009, Greece had a primary deficit of 7.9%. On the assumption of 2% nominal growth during the adjustment period, a marginal interest rate of 6% on future debt, the primary balance Greece needs to achieve debt sustainability is a surplus of almost 5%. The total size of the adjustment is thus 13 percentage points. The only advanced economies in modern times ever to achieve a shift of such scale were Denmark, Sweden and Finland during the 1980s and 1990s. But they benefited from vastly superior growth.

The Greek general government had total expenditures of 44% of GDP in 2008, and tax revenues of 41% of GDP. If the 13% adjustment effort were to come entirely from expenditures, this would imply a cut in public spending of 30% of GDP. Conversely, if all the adjustment were to come from taxes, it would require a tax hike of a similar scale. Given the degree of corruption and the inadequacy of the Greek tax collection system, there is no way that taxation could take the lion share of this adjustment.

These numbers are future projections, and thus liable to errors. The interest rate Greece would have to pay may be a little under 6%, but probably

not much less. Maybe, for reasons unknown in 2010, the reform process produces such high rates of economic growth that the adjustment is self-sustainable. The IMF calculated that the debt levels will stabilise at just under 150% of GDP. To get down to a level of 60% of GDP, the reference criterion under the Maastricht Treaty, would require an implausible increase in potential growth – at a time when it is not clear whether the world economy can sustain the growth rates of the previous decade. A factor that aggravated the situation in Greece was a loss of competitiveness during that period. Greek competitiveness fell by 15% to 30% against the euro area average during the last decade – depending on which measure is used. One metric is the current account deficit, which was 11.2% of GDP, a clearly unsustainable position, even inside a highly integrated monetary union.

Apart from a fiscal retrenchment, Greece would also need to take measures to restore competitiveness, i.e. reduce wages. But it must do so by avoiding a depression, which in turn would endanger the adjustment programme, as tax revenues would collapse. It is not impossible that Greece can succeed, but based on what we know in 2010, it did not seem plausible, even under the assumption that Greece would stick to the agreed programme word for word.

Greece was thus faced with the following universe of options:

1. Leave the euro area
2. Default inside the euro area, or negotiate a restructuring of the debt
3. No default, reforms, internal devaluation, fiscal retrenchment

Option 3 is obviously preferred by all actors, but there is no guarantee that option 3 can physically work. If the nominal rate of growth were to decline to 0% over the entire adjustment period, the primary surplus necessary for debt sustainability would jump to over 7%. Such a surplus is extremely hard, perhaps impossible to achieve during a recession. This shows how important it is to avoid a self-sustaining slump. The consolidation under option 3 would get progressively harder, and the danger of an Argentinian-style vicious circle is immense.

The problem is that Greece will not just have to make an improbable fiscal adjustment, but it will also have to seek a fall in prices and wages. These two goals may well be inconsistent. And this is why the Greek bond spread to Germany rose from almost 0 to over 10% (it briefly peaked at over 20%). A 10% spread is roughly consistent with a 30% probability of a 30% loss under a risk-neutral setting. In view of the economic analysis of the situation, that would seem to be an entirely appropriate rating for a ten-year bond, even under the presence of a protective shield from the EU – which is set up only to last for three years.

Greece has no interest to default, or restructure, straight away. The country has been taken off the international capital markets for the duration of the adjustment programme. The danger arrives once the adjustment produces the first primary surplus. This is the moment, when a country is no longer dependent on the capital markets to finance public expenditure.

But given the large internal imbalances in the euro area, a default would have serious implications for the Northern European banks. They are, essentially, the counterparty to the large Greece current account deficit. This is an estimate of the exposure in May 2010:

Altogether, European banks have invested more than EUR 240 billion in

Table 1

Estimated Exposure of European Banks

French banks	EUR 55 billion (Société Générale, Crédit Agricole)
Swiss banks	EUR 47 billion
Greek banks	EUR 40 billion (14% share of the total volume)
German banks	EUR 30 billion (Deutsche Bank, Commerzbank, Hypo Real Estate)

Source: Barclays Capital.

Greek sovereign debt, and approximately 10% of all sovereign bonds in the euro area are Greek.

This is the reason why it was impossible for the German government to accept the advice of countless German economists, who advocated a Greek default, or a Greek exit from the euro area. Both recommendations would have triggered another European banking crisis, which would have cost the governments potentially more than the bailout for Greece. A bank recapitalisation would have had to be met out of current expenditure, while the EFSF is essentially a special purpose vehicle that borrows on the capital markets. So far – June 2010 – the rescue of Greece has not cost the European taxpayer a penny – thanks to the instruments of modern finance, which let its users bask in a false sense of security, as contingent debt piles up. The bill comes if, or rather when, Greece defaults.

Spain: a Private Sector Crisis

Unlike Greece, Spain has studiously followed all the rules of the stability and growth pact. Until the recession, the country used to run a budget surplus. The debt-to-GDP ratio was around 40%, well below those of Germany and France. What the rules did not foresee, was that the advent of monetary union produced a housing bubble, which in turn created a private sector debt problem. Those debts landed in the banking sector, which is indirectly guaranteed by the Spanish government. Spain's sovereign debt problem is thus a contingent debt problem.

Like Greece and Portugal, Spain also has a competitiveness problem. Depending on which measure one uses, Spain needs a real devaluation of 20% to 30%, which in turn would require falling wages or prices – or at least stagnating wages and prices on the assumption than Northern European wages and price continue to rise by moderate amounts.

One measure of the loss of competitiveness is the current account, which reached a deficit of 10% in 2008. This deficit reflected an even stronger private sector financial deficit (as the government sector was in surplus). The debt of the Spanish private sector ended up, either directly or indirectly via Spanish banks, in the euro area banking sector. According to data from the Bank for International Settlements[1] German banks had exposures to Spain in the order of EUR 170 billion, while French banks had exposures of EUR 210 billion.

[1] *BIS Quarterly Review. June 2010. Retrieved from www.bis.org*

Because of the post-Lehman bank guarantees, the debt of the Spanish banking sector are ultimately debts of the Spanish state, as a result of which investors treated the risk of the Spanish banking system as a contingent debt problem of the Spanish government. This is why Spanish spreads have been rising, despite the fact that the Spanish fiscal position has remained sound.

As with Greece, Spain would require very strong growth rates to make the adjustment – which would logically have to consist of shifting economic resources from the construction sector to the industrial sector. But that in turn would require a significant improvement in competitiveness, which in turn is likely to have severely negative implications on economic growth. That in turn is likely to exacerbate the private sector's contingent debt problem. Spanish households and banks are facing the prospect of debt-deflation, as the real value of their debt is likely to rise for as long as the adjustment takes place.

The Spanish government responded with the imposition of labour market reforms in June 2010 – which, at the time of writing, had yet to be approved by the Spanish parliament – while the central bank has forced mergers among the country's savings banks, which hold most of the mortgage debt, and toughened the accounting rules. While the reforms are a step in the right direction, it is hard to see how a reduction in dismissals costs – from 45 to 30 days per year worked – are going to produce a macroeconomic miracle. These costs are still the highest in Europe. Their short-term effect is surely to increase unemployment, as it makes it cheaper for companies to fire staff.

The country is thus very likely to face a prolonged slump. The uncertainty that arises from this prospect is how the Spanish political system will react to this. Will it accept the adjustment, or will political forces arise that advocate default – either inside or outside the euro area. And when the recession enters its later stages, will Spaniards not begin to start blaming the euro or other European countries for their problems? The answer to these questions will have a direct bearing on the risk the central banking system is taking on when purchasing Spanish bonds.

The Dilemma of the Central Banks

Apart from the uncertain political scenarios, what makes this situation so complicated, and risky, is the presence of large cross-border financial flows. German and French banks have built significant exposures to both Greece and Spain. The combined French and German bank exposure to the four countries is about USD 1 trillion. Now this is not all bad debt, even on the most pessimistic of assumptions, but even relatively small losses on those debts could knock the European banking sector off course, considering that these losses come on top of the US-structured product losses, which have not yet been written off for their most part.

The euro area's problem can be summed up as a combined banking and

fiscal crisis in the presence of large cross-border financial exposures. It is not easy to disentangle the private and public sector risks, given the state guarantees to the banking system. Because of the inter-connectedness, one can observe that the share prices of German and French banks correlate almost perfectly with Greek sovereign CDS. In other words, the interconnectedness has the consequence that investors perceive various euro area entities to be of identical risk.

These are risks the central banks are taking on with their bond purchasing programmes. If a large part of southern European private and public sector debt ends with up with ESCB, the risks would be severe. The system would encounter losses, which in extremis, might require a recapitalisation.

This is why the ECB was so keen to get the European Financial Stability Facility (EFSF) up and running to ensure that the ultimate responsibility lies in the realm of fiscal policy, not monetary policy. If the EFSF was allowed to turn into a full EU-body, it could form the core operational institution of the euro area, an extended European debt agency, the core of a fiscal union. In this role, it could even issue euro bonds, eventually covering a certain percentage of the Member State debt. From the perspective of the investors, that would be one of the better outcomes.

But if, for example, the EFSF's mandate was not renewed in 2013 – an election year in Germany after all – there may be a severe risk of sovereign default by Greece in the absence of any new backstop agreement. By then, most of the Greek bonds will be in the hands of the ESCB and the EFSF because most of the existing bonds will have expired by then.

This scenario in turn would give rise to a problem for the ESCB. The German taxpayer would not only have to co-finance the losses of the EFSF, but also incur a loss of the ECB, or possibly have to recapitalise the system. The answer I am hearing from politicians who support the EFSF is that this would absolutely not happen, both for political and legal reasons. Politically, it would be exceedingly tough to demand austerity at home, while transferring billions – actual fiscal billions, not virtual money – to recapitalise the ECB or the EFSF.

In other words, there are sufficient reasons to expect an accident along the way. The EU has taken a course where it is likely to hit a critical watershed in a few year's time, at which point it would have to make a binary decision about the future of the euro area. In or Out. Fiscal union, or breakup. As the answer is unknown and unknowable, nervousness about the euro area is likely to persist.

The ESCB and the ECB have no way of answering that question either. But they must keep in mind that they are pursuing risky policies without a political backstop agreement. It is not clear how the political system will react to those losses. Even though the bond purchases are not intended as a programme of quantitative easing, there are some parallels in terms of risk. The Fed's Quantitative Easing (QE) programme is ultimately guaranteed by the Treasury – or by its ability to print money. The European Treaties explicitly and implicitly exclude both options. This is why the ESCB bond purchasing programme is inherently more risky than the Fed's programme of QE.