CEPS COMMENTARY
Thinking ahead for Europe

Neither a borrower nor a lender be

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For loan oft loses both itself and friend,
And borrowing dulls the edge of husbandry
Hamlet, Act I, scene 2, 75-77

Europe's leaders should have heeded Lord Polonius' wise words to his son Laertes. The countries now struggling under a mountain of debt should have realized earlier that excessive reliance on borrowing invites excessive consumption and wasteful investment. But the leaders of Germany and the other creditor countries should also be aware that a lender can lose both its capital and its friends.

This is what is now happening with the rescue operations of Ireland and Greece. Irish politicians and many commentators have heavily criticized the high interest rates (close to 6%) the European Financial Stability Fund (EFSF) has imposed on the €67 billion loan it will provide to the country. This interest rate is far greater than the growth rate Ireland can hope for and will thus lead to a snowball effect under which high interest payments increase the debt burden faster than the capacity of the Irish economy, and thus its government, to create the resources to service this debt.

However, this widespread impression that the 'bail-out' of Ireland constituted an onerous interest rate '*diktat*' by the EFSF is misleading. A much larger 'bail-out' on very generous terms has taken place silently via the balance sheet of the ECB. Here again public attention has focused on a side show, namely the direct purchases of distressed government bonds by the ECB. However, the portfolio of government bonds held by the ECB under its 'securities markets programme' has so far amounted only to about €70 billion, of which only part will have been in Greek and Irish bonds. But more importantly, the ECB has not provided any fresh money to the countries concerned by buying their bonds in the secondary market. It has only increased the price at which some investors were able to sell their holdings of Greek and other bonds.

The ECB is, however, providing direct support to the countries in difficulties via its normal monetary policy operations, which allow the banking systems of these countries to refinance themselves at the official rate of 1%. This has resulted in an infusion of liquidity of an unprecedented magnitude given the small size of these economies. For example, the banking systems of Greece and Ireland have now received funding worth about €100 billion each, representing 40% of national income in the case of Greece and close to 80% of GNI in the case Ireland.

It is clear that without this injection of essentially free liquidity, both countries would have been insolvent a long time ago. This huge infusion of liquidity is of course just a by-product of the way the ECB's monetary policy works and not a tailor-made approach for countries in difficulties (unlike the securities markets programme and the EFSF), but it implies a considerable subsidy given that few Greek or Irish banks could have funded themselves at reasonable terms in the interbank market over most of last year.

Moreover, on top of the funding received via the normal repo operations, both the Greek and the

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Irish central bank support their banking systems with considerable amounts of 'emergency liquidity assistance' (ELA). The ELA is in effect money creation by the national central bank. It is used to pay out the foreign depositors who are running from the Irish banks as quickly as they can. The Irish central bank charges reportedly a 'penalty' interest rate of 3% on its ELA loans, but given that the banks effectively belong to the government and that the interest on the ELA will remain with the Irish central bank, the interest rate on ELA loans remains within the country. All the Irish central bank has to do is to reverse the operation some time later. ELA thus represents effectively a zero interest loan to the country.

ELA is shrouded in secrecy (because supposedly nobody is supposed to know that the Irish banks are in difficulties). But the balance sheet of the Irish central bank suggests that it has provided Irish banks with about €40 billion in emergency liquidity. This is equivalent to about 30% of Irish GNI.1

How much is the subsidy of cheap ECB funding worth? The risk premia for banks are usually somewhat higher that of their sovereign. The risk premium for the Greek government is about 800 bps, that of Ireland around 600 bps. This implies that Greece is currently receiving a subsidy worth around 3.2% of its GNI. For Ireland the sum of 'normal' ECB funding and ELA, which amount to about 110% of GNI, must be worth close to 7% of national income.

Insolvency can certainly be avoided as long as liquidity is (almost) free and available in unlimited amounts. However, unlimited cheap financing ('liquefaction') has its disadvantages. First of all, it is obviously not a solution for insolvent debtors; it just postpones the day of reckoning – and makes it more painful when it does arrive because the debt burden will be even larger.

Secondly, it is addictive. The European Central Bank will remain by far the cheapest source of funds for banks in the euro periphery. Those countries will thus try to maintain and increase their recourse to ECB funding for as long as possible, with the result that the risk on the balance sheet of the ECB will also increase. This is why the ECB recently had to tighten its eligibility criteria for the collateral it accepts. Banks in the periphery (and some weak banks in core euro states) had obviously a tendency to transform ever-more risky parts of their assets into securities that they could use as collateral at the ECB's windows. Is there a 'third way' between bankruptcy and continuing unlimited liquidity support? The obvious way out should be controlled rescheduling and/or restructuring in order to avoid turning part of the euro periphery into 'zombie countries'.

The problem is that no debtor will ever appear insolvent (and admit to it) in an environment of essentially free money. As long as interest rates remain close to zero and liquidity is available without limits, no debtor will have an interest to engage in a restructuring or rescheduling.

This is the EU's Shakespearean dilemma: political authorities have to take over the function of capital markets. The ECB and the EFSF must now decide which countries and which banks have access to funding and on what terms.2 They risk losing "both itself and friend". Politicians on all sides must be very careful about complaining about unfair loan terms.

[1] For completeness, one should note that the first large ELA operations occurred in 2008 when the Belgian Central Bank gave €30 billion to Fortis and the Bundesbank lent €80 billion to HRE (Hypo Real Estate Holding). But both loans amounted to a small fraction of GDP and were repaid within a few months.

[2] Representatives of the ECB have rightly pointed out that the capital market had made a fundamental mistake in funding Greece for too long a period of time at excessively low risk premia; and that the market (and the ratings agencies) might now err in the opposite direction by overestimating the risk of insolvency. But how can one be sure that the ECB is right to lend 40% of GDP at a zero risk premium?