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A Euro Portfolio of Collateralized Liquidity

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Once the euro governments have committed to viable economic policies, the ECB can defrost the European bond markets by requiring a basket of euro wide sovereigns as collateral and by easing the haircut. This fits perfectly within the ECB's mandate and minimizes the risk of inflation.

1. Spreads

Except for the still untenable Greek situation, bond spreads over the German bund and debt levels are back or slightly above the levels at the high time of the EMS. At the time spreads reflected the inflation differentials and exchange rate risk, now it is credit risk. With similar elevated debt levels as France, the UK and US experience considerable lower spreads, due to the option value to inflate away part of the debt embedded in their freely floating exchange rate. While the current euro spreads levels are still manageable, their rapid rise and the complete collapse of the interbank market is quickly turning the muddling through scenario into the unsustainable.

2. Discipline

Continued procrastination would imply disaster, but there is still a bit of time for governments to get their act together. The fear for moral hazard and inflation is ingrained in the Northern states and has structured the stability pact and the single aimed Maastricht treaty. Therefore the ECB will not take action before countries under duress have devised plausible economic strategies. Measures comprise selective austerity but rather should be much growth oriented. This entails liberalizing labor markets, privatizing state owned companies and promoting entry into markets to escape the recession spiral of austerity deflation. Southern governments may need the commitment device of the IMF participation. The long run prospect of a union with powers to resolve the fiscal problems of an individual country by temporal suspension of its budgetary sovereignty and the transfer of banking supervision and bailout to the ECB would certainly help.

3. Liquidity

With proper macro policies in place, the ECB could act to unlock markets. The IMF and EFSF facilities are too small to guarantee the roll-over of the Southern debt for long. The North is unable to finance the EFSF sufficiently without threatening its own fiscal position and the leverage is implicated. Eurobonds are a bridge too soon for the Northern public opinion and

lend themselves too easy to moral hazard without the proper governance and disciplining devices in place. Remains the ECB. In the US and UK the central bank can provide the necessary liquidity by buying its government debt. But direct purchase of individual country debt is forbidden by the Maastricht treaty for the fear of moral hazard by individual governments. Nevertheless, in my opinion the ECB still has one option that seems to have gone unnoticed so far.

4. Collateral

Currently commercial banks obtain euro's by borrowing from the ECB and placing collateral. Often this collateral is a particular government bond. Instead of accepting a particular bond, the ECB could require a basket of euro government bonds as collateral. The weights of this basket could consist in the countries' capital keys in the euro. The average haircut on such a basket should also follow the capital keys. Collateral rules perfectly fit within the mandate of the ECB and importantly, do not in any way go against the Maastricht treaty. A first effect of this rule is the signal that underlying the euro there exists a euro wide bond market rather than a country based market. More importantly, the collateral rule will trigger banks that are short in paper of countries with elevated interest rates into buying this debt and selling sovereigns from the Northern countries. This will unlock the frozen interbank market and bring the interest rate spreads down. It gives the ECB the opportunity to easily provide extra liquidity as is done in the UK and US, by lowering the average haircut. It also allows the ECB to withdraw liquidity from the market once markets are back to normal, by raising the haircut. The widely advocated alternative is to buy sovereigns from a particular country. In the views of many this is against the spirit of the Maastricht treaty. It also increases adverse selection by allowing commercial banks to ride the ups and downs of the intra euro bond carry trade and makes it difficult to reverse the ECB position in the amassed sovereigns, as this would bring the crisis back by driving up the spreads. The ECB would fall hostage to the Southern governments.

5. Conclusion

Once governments have embarked on sound economic policies that are growth enhancing and have the short and long run commitments devices in place, the ECB can indeed help to restart the interbank market and bring spreads down, by changing to a collateral rule that requires a basket of euro area sovereigns.