SWP Comments

Stiftung
Wissenschaft und
Politik

German Institute
for International and
Security Affairs

Liquidity and Sovereignty

The Eurozone Needs a Lender of Last Resort
Heribert Dieter

The financial crisis that hit Greece in early 2010 has demonstrated a fundamental weakness in the construction of the eurozone. The assumption that the criteria of Maastricht for fiscal policy would be sufficient to exclude liquidity crises has been proven false. The eurozone needs a lender of last resort that supports member countries in the event of liquidity shortages. However, theses credit lines should only be given if sufficient collateral can be provided. Nonetheless, the provision of a last-resort lending mechanism within the eurozone does not rule out the possible bankruptcy of a member state.

In the first months of 2010, the depth of the Greek financial crisis became evident. Greece has accumulated a public debt of about 300 billion euros as Greek society has lived for years beyond its means. In 2010, Greece will have to raise 53 billion euros in the financial markets, and there are persistent doubts as to whether private lenders will be willing to buy Greek bonds later this year. Despite relatively high interest rates, lenders could be unwilling to continue lending to Greece. The country might be facing a liquidity crunch.

The Greek case highlights a structural weakness of the eurozone. If a member country is temporarily facing liquidity problems, the eurozone does not offer a mechanism to bridge those phases, at least not for sovereign borrowers.

What constitutes an effective lender of last resort?

There are numerous cases of temporary liquidity problems in the history of international finance. There was a prominent case in Mexico, which experienced an acute shortage of funds in 1994/95 and faced illiquidity. Private market participants were not willing to lend to Mexico irrespective of the interest rates offered. The United States, the International Monetary Fund (IMF) and the Bank for International Settlements provided Mexico with emergency loans of about 50 billion dollars. The United States, however, required collateral in case Mexico defaulted on its debt. Mexico pledged future earnings from oil exports. Thus, the Clinton administration was able to avoid interfering in the internal affairs of its southern neighbour while helping the

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country in a moment of panic. It has been a model case for crisis lending ever since.

Whilst the US government and the IMF could not prevent panic from spreading among lenders, the provision of generous and immediately available credit lines swiftly terminated the speculation against Mexico. For the US government as well as the IMF, the lending operation to Mexico did not entail major risk, for the repayment of the loans was secured by future receipts from oil exports. The willingness of Mexico to provide collateral was, of course, essential for this arrangement and for the subsequent rapid recovery from the panic in the financial markets.

After the traumatic experiences following the Asian financial crisis in 1997/98, policy makers have tried to develop mechanisms that ensure the provision of liquidity in a crisis. First and foremost, East Asian economies have dramatically increased their foreign currency reserves in order to guarantee the availability of foreign exchange in the event of a panic in the financial markets. In addition, these economies have agreed on bilateral swap agreements in the Chiang Mai Initiative. Participating countries have agreed to swap domestic currency, which can always be supplied, for foreign exchange. In this scheme, domestic currency serves as collateral. In effect, participating economies in East Asia have created a network of public lenders of last resort.

The concept and principles of last-resort lending were developed by the English economist Walter Bagehot in the 19th century. He suggested three criteria for successful lending in a financial crisis. First, a lender of last resort should provide generous amounts of liquidity. Second, the interest rate charged should be above the pre-crisis market level, but below the market level at the height of the panic. Third, the borrower should provide sufficient collateral. In short: "lend freely, at penalty rates, against good collateral".

Loans and collateral have to work in conjunction with one another. A supranational lender of last resort can only be established effectively if the lender can access the collateral. This is exactly the way a lender of last resort operates in the domestic domain. In a banking crisis, for instance, a central bank provides liquidity, but only against collateral. Within the eurozone, the European Central Bank (ECB) acts as a lender of last resort for the (private) banking sector. For public borrowers, this opportunity of liquidity provision does not exist. Ironically, Greek and other commercial banks can use Greek government bonds as collateral in liquidity operation with the ECB.

In the event of a panic in the financial markets regarding public debt, the only two alternatives currently available in the eurozone are default or the application for support from the IMF. The provision of liquidity by the European Commission, the ECB and even bilateral loans are explicitly ruled out in the current regime.

Traditionally, the lender of last resort has been a public player, e.g. a government or a central bank. However, in theory a private lender of last resort could fulfil the same function and provide liquidity against collateral when the access to other forms of finance is temporarily not available. Even if financial markets were not willing to buy conventional bonds, players in the private sector might be willing to provide credit against collateral.

Does the concept fit the Greek case?

The plan – inspired by the Mexican case – would require the provision of conservatively valued collateral by the Greek government in exchange for short-term credit. Of course, the question arises whether this concept would fit the Greek case and whether the government in Athens would be able to provide sufficient collateral. Since previous governments showed very little interest in privatisation, the Greek government has become surprisingly wealthy. Inter alia, the Greek state owns hotels, ports, airports, banks, insurance companies and utilities. The Greek economist Michael Massourakis estimates the value of real estate in government ownership at 300 billion euros. For example, the Hellenic Public Real Estate Corporation (KED) has holdings in 72,000 properties, and the state is the only shareholder of KED. In 2007, the IMF estimated the value of the Greek government's shares at 42 billion euros. There can be little doubt that the Greek government could provide collateral for bridging loans.

This kind of liquidity help would have a number of advantages compared with the other available options. The countries of the eurozone would show solidarity and would help, but they would not deprive Greek society from finding its own solution to the self-inflicted mess. The risk of temporary illiquidity would be removed, and the risk premia that markets are currently demanding would probably fall. Market participants would receive the signal that a Greek default from a liquidity crunch is not likely. Above all, it is a concept that the governments of the donor countries could justify in their domestic political constituencies. This is a significant plus, considering the justified unwillingness in potential donor countries – including Germany and the Netherlands – to make significant financial contributions to the cleaning-up of Greece's Augias stables.

Disadvantages: Which risks remain?

Of course, this concept has significant disadvantages. The main one is: How shall the collateral provided be sold in the event of a default? The lenders could be forced to sell significant amounts of real estate and other assets in difficult and stressed markets. A trust fund that holds and potentially markets the assets would have to be created, and the lenders would have to be willing to exercise their rights.

In addition, the provision of liquidity does not solve the underlying problem: Government spending is too high when set against revenue. The probably inevitable cutting of wages and statutory benefits will not be achieved if fresh liquidity is provided. But Greek society would gain valuable time for the inescapable restructuring. Hitherto, a significant part of Greek society appears to be unwilling to make sacrifices and seems to be hoping for a continuation of established patterns. Given the currently discussed choices – a protectorate or bankruptcy – the Mexican model is a plausible third way that respects both the interests of Greece and those of the other member countries of the eurozone.

Alternative options for the eurozone

Of course, there are alternatives to the creation of a lender of last resort within the eurozone. Currently, three concepts are being debated: the granting of loans by other eurozone economies – tied to strict conditionality; an invitation to the IMF; and the exclusion of any foreign help.

The European Union is steering an unclear course but appears to prefer the first option. Greece has all but lost the ability to decide about its fiscal policy. In essence, the countries of the eurozone have asked the Greek government to surrender part of its sovereignty in exchange for a yet unspecified commitment to provide emergency financing in the coming months. This path, however, is extremely risky, both for Greece and the countries of the eurozone. By effectively turning Greece into a protectorate of the donor countries, Greek society is deprived of the opportunity to find its own solutions for the country's economic woes.

In development co-operation, it has been proven time and again that ownership matters. Seemingly clever solutions that are imposed on a society often backfire. Reform is imposed rather than owned. This holds for Greece as well as for any other society. Over time, this approach can easily turn into lasting resentment against the European Union. Brussels – and not the irresponsible Greek governments of the past – will be made responsible for lower wages and other deteriorations. This path is a recipe for tragedy.

In other countries, the prospect of loans to Greece is facing enormous and justified opposition. Observers have been asking how the current Greek government will ensure that loans will neither be wasted nor disappear in corrupt channels. In addition, a bailout for Greece would reward the unsound fiscal policies of the last three decades. Furthermore, it would create a precedent for other economies in the eurozone.

Needless to say, it is unrealistic to expect a sustainable change in the Greek public administration overnight. Widespread corruption, regular tax evasion and limited effectiveness of tax authorities are just a few of the issues that plague the Greek public sector. These problems are not new, but none of the previous governments in Greece addressed them successfully. Membership in the eurozone resulted in a decade of low interest rates, but instead of using this opportunity, the Greek government hired an additional 100,000 public servants. Today, Greece employs 900,000 officials, as many as the United Kingdom.

However, the problems are not limited to the government. An economy that in 2008 exported goods worth 29 billion euros – and imported merchandise worth 94 billion euros – needs a major correction of its production and consumption patterns. It will be difficult, if not impossible, to achieve this if Brussels provides fresh money.

An alternative is to invite the International Monetary Fund. The IMF is a seasoned crisis manager, but on its own it could not rescue Athens. Even if the Fund were to broaden its lending regulations, in 2010 it could probably not provide more than 10 billion euros – too little for effective last-resort lending. In the event of further panic, the IMF would need support from other lenders, which it had in previous financial crises. Both in the Mexican and the subsequent Asian crises, the Fund received help from other lenders, who could ask for collateral. However, the IMF would probably be the best advisor for Greece with regard to creating a leaner and more effective public administration in Greece.

The last option is not without severe risks. Strictly speaking, it would require that the Greek government sort out the mess it has created over decades. Bondholders, who have enjoyed considerable risk premia in the past, would have to accept a rescheduling of Greek debt and a discount on their claims. In theory, that is the preferable approach. Rather than bringing in a scapegoat, Greek society would have to find its own way out of the crisis. However, this approach requires time, and in the current climate the Greek government could become illiquid in the course of 2010.

Prepare for the next crisis

Independent of the current debate on the Greek crisis, the European Union should discuss the handling of the liquidity crisis both in the eurozone and in the wider European Union. The criteria of the Treaty of Maastricht have obviously not been sufficient enough to prevent a number of countries from find themselves in calamities. Policy makers in the eurozone have to develop a mechanism to deal with liquidity crises.

For the current case, the Mexican model probably provides the best alternative. Needless to say that no alternative is really attractive. The worst option – both for Greece and for the future of European integration – would be the establishment of a Brussels protectorate. A default would have severe repercussions for Greece, but it would probably do less damage to the European integration process than to Athens, which would be incapacitated and inevitably result in lasting resentment. The model applied in Mexico is a plausible alternative to the options of default or a Brussels protectorate. The granting of emergency loans against good collateral would be considered both in the interests of Greece as well as the legitimate interests of the donor countries.

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ISSN 1861-1761

(English version of SWP-Aktuell 23/2010)