Intra-eurosystem debts

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- Germany is a reluctant supporter of the EU funds which are being used in the 'bailout' of Ireland, and it insists on strict 'austerity' conditions, concerned about risk and moral hazard.
- However, through its central bank, Germany is currently lending €325bn (December 2010) to other central banks in the eurosystem. The Central Bank of Ireland (CBI) has borrowed €146bn from the eurosystem in order to support its banks.
- This 'bailout' of Ireland via the eurosystem is larger than its official EU 'bailout' (€146bn as against €67bn) and much cheaper (1% interest as against 5.8%), but it exposes Germany to similar risks.

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http://www.lancs.ac.uk/staff/whittaj1/eurosystem.pdf

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The operation of the eurosystem

In eurozone countries, each national central bank (NCB) deals with its banks according to rules[1] administered by the European Central Bank (ECB). Under routine operations, NCBs lend to their banks for periods of one week (main refinancing operations) or longer, through repurchase agreements (repos) against acceptable collateral. Since October 2008, refinancing has been applied by 'full allotment', meaning that the NCBs satisfy all bids for repo lending at the ECB's main refinancing rate, currently 1%.

Retail banking transactions lead, in general, to debts between one bank and another. These wholesale debts may be cleared in the interbank market by unsecured loans, by loans secured against assets, or transfers of assets between the banks.

Wholesale debts between banks of the same country may also be cleared by transfers of the banks' reserve deposits at the country's central bank. When a retail transaction causes a debt between banks in different eurozone countries that is not cleared in the interbank market, this creates a claim between their respective NCBs.

Suppose a deposit is moved from an Irish bank to a German bank. If the German bank is unwilling to accept payment in the form of a claim on the Irish bank, directly or via another interbank counterparty, the debt is settled via their central banks. The Irish bank makes up for its lost deposit by obtaining greater refinancing from its NCB, *i.e.* the CBI (Central Bank of Ireland); the German bank acquires a claim on the Bundesbank (German NCB), recognised as a net fall in the amount of refinancing sought by the German bank; and the Bundesbank acquires a claim on the CBI.

Debts between NCBs created in this way are aggregated across the eurozone by TARGET2 (the EU gross settlement system). According to the ECB:

> *"Intra-ESCB [i.e. intra-eurosystem] transactions are cross-border transactions that occur between two EU central banks. These transactions give rise to bilateral balances in accounts held between those EU central banks connected to TARGET2. These bilateral balances are then assigned to the ECB on a daily basis, leaving each NCB with a single net bilateral position vis-à-vis the ECB only. This position in the books of the ECB represents the net claim or liability of each NCB against the rest of the ESCB."*[2]

Intra-eurosystem debt arising from cross-border transactions, December 2010

euro billions

claims on other NCBs		liabilities to other NCBs	
Germany	325.5	Ireland	*146.1
Luxembourg	68.0	Greece	87.1
Netherlands	40.5	Portugal	59.9
Finland	19.7	Spain	50.9
Italy	3.7	France	28.3
error	-0.3	Austria	*23.7
		Belgium	13.9
		Slovakia	*13.8
		Cyprus	6.4
		Slovenia	2.1
		Malta	1.3
		ECB	21.2
		error	2.4
total	457.1		457.1

source: NCB financial statements and annual accounts; total from ECB annual account 2010
** = estimates*

Intra-eurosystem debts carry interest at the ECB's main official rate (currently 1%, but expected to rise) and outstanding values at the end of 2010 are shown in the table. The Bundesbank is doing most of the lending (€325.7bn: 70%) and the CBI is the biggest borrower (€146.1bn), followed by the NCBs of Greece, Portugal and Spain.

[1] The Statute of the European System of Central Banks and of the European Central bank. The European System of Central Banks (ESCB) is known as the 'eurosystem'.

[2] ECB annual accounts 2010, page 9.

Total eurosystem lending at the end of 2010 was €457.1bn and Chart1 shows how this has grown by a factor of 7 since 2004.

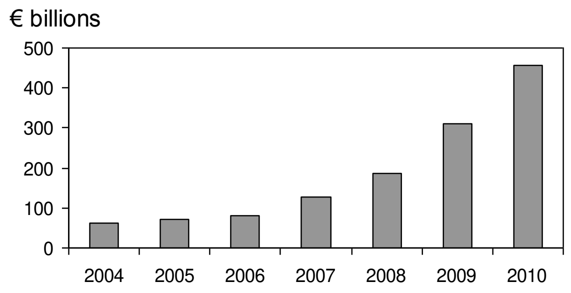

Chart 1: total intra-eurosystem claims
source: ECB annual reports

CBI support for Irish banks

The large expansion of CBI debt to the eurosystem is a result of its banks' loss of deposits, maturing debt that they have been unable to refinance and limited access to the interbank market. This follows doubts about the banks' solvency and about the capacity of the Irish government to honour its guarantee of its banks' liabilities.

While most of the CBI lending to Irish banks has been granted in the normal way via repos against ECB-approved collateral, increasing use has been made of Emergency Liquidity Assistance (ELA), with this form of support reaching €50bn at the end of 2010 (see Chart 2). ELA is overnight lending granted by the CBI on its own initiative. It is supposed to be for short periods and is not subject to ECB collateral requirements.

Another way in which Irish banks are borrowing from the CBI while avoiding the ECB's usual collateral rules is by issuing unsecured debt to themselves which is then given an Eligible Liabilities Guarantee[3] by the Irish government. The ECB has deemed that this credit enhancement makes the debt acceptable as collateral for ordinary repo funding, and €27bn of bank debt had received this guarantee at the end of 2010.

The ECB could, of course, tighten its collateral standards and its governing council is empowered to order the CBI to cease ELA[4]. However, the burden would then fall on the Irish government as it has guaranteed its banks' liabilities, and it is no position to bear this. If the Irish government assumed all its banks' current debts to the eurosystem, this would double its gross debt/GDP ratio to around 180%.

CBI debt to the eurosystem will fall as the National Asset Management Agency (NAMA) disposes of foreign assets formerly owned by the banks. But there is a reluctance to engage in 'firesale' disposals at marked-down prices and suspicions that not all of the banks' doubtful assets have yet been identified.

Hence, if Irish banks are to remain in business, the CBI must continue funding them by whatever means can be devised to bypass the ECB's already-diluted collateral requirements. In turn, other NCBs find themselves lending to the CBI. It is likely that this eurosystem support for Ireland will endure for some time to come.

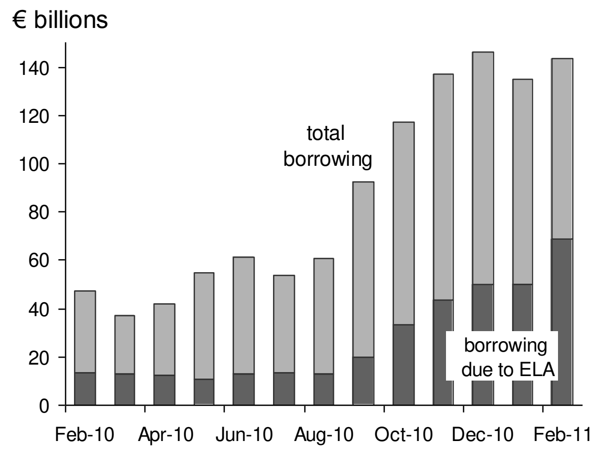

Chart 2: CBI borrowing from the eurosystem
source: Money and Banking Statistics, Central Bank of Ireland

In recognition of this continuing commitment, the latest plan (March 2011) being discussed is to replace 'short term' ELA with more formal ECB-approved lending. The ECB hopes this

[3] Details of the ELG scheme are published by the Irish National Treasury Management Agency (NTMA).

[4] The ECB has expressed concern about the quality of collateral for Irish ELA in opinion CON/2010/92.

will enable it to apply more pressure on the Irish government to restructure its banks' assets.

The ECB may not like it, but unlimited sharing of NCB liabilities is a necessary condition for the continued existence of the euro as a multinational currency. If Ireland had retained its own currency but fixed it to the euro, the outflow of foreign (euro) assets caused by the banking crisis would long ago have caused a devaluation of the Irish currency.

However, with the single currency, the liabilities of any NCB (euro currency and bank reserves) are indistinguishable from the liabilities of other NCBs. Thus the CBI can freely incur 'foreign' liabilities (*i.e.* within the eurosystem), which enables the 'fix' of its own euros against the euros of other NCBs to be upheld.

The EFSF bailout

Under the arrangement agreed in November 2010, Ireland is scheduled to borrow €67bn from the EFSF (the European Financial Stability Facility, backed by EU governments) and the IMF over the period 2011-13 at an average interest rate of 5.8%, conditional on continued fiscal 'austerity'.

As with the earlier bailout-cum-austerity package for Greece, this loan is ostensibly to help the Irish government over its borrowing difficulties and avoid default. But more austerity will impede economic growth, and the fact that market yields on both Irish and Greek government debt remain high indicates that investors are unconvinced.

Nor are investors likely to be reassured by the reticence of Germany and the other bailout guarantors. It took months to reach agreement on the Greek bailout and more months to create the EFSF structure. There is now prolonged argument over the ESM (European Stability Mechanism), which is intended to provide a continuation of support after the EFSF expires in 2013, in exchange for even greater austerity in the name of the Competitiveness Pact.

The Germans are naturally concerned that wholehearted support for bailouts would create moral hazard and jeopardise their own credit standing. And while they have a strong interest in eurozone banks and sovereigns staying afloat, they would prefer the Irish to bear the cost of cleaning up their banks and the Greeks the cost of their fiscal incontinence. This means they must stick to the increasingly untenable assumption that these economies will ultimately generate sufficient surpluses to make their debts manageable.

For all Germany's fear of becoming locked into permanent support for the Irish and others, the irony is that they are already providing 'bailouts' via the eurosystem. In the Irish case, this is both larger than the EFSF bailout (€146bn as against €67bn) and much cheaper (1% interest as against 5.8%). And the ECB has progressively had to reduce its collateral standards, for instance, by changing its rules to continue accepting Greek government debt after this was downgraded to 'speculative'. The ECB's collateral rules are effectively being driven by the financing needs of the weakest banks.

This creates its own moral hazard problem. So long as banks have access to cheap funding from the eurosystem, they are less inclined to seek funds elsewhere. Likewise, the Irish and Greek governments, having guaranteed their banks' liabilities, prefer that support comes from the eurosystem rather than from themselves. The ECB tries to mitigate this moral hazard problem by making time-inconsistent statements of its intentions to tighten its rules and procedures for liquidity provision.

Should the ECB be concerned?

A primary concern of the ECB is that, in keeping with its mandate to target inflation and its desire to hold down inflation expectations, it should not be seen to condone the 'monetisation' of government and private debts. This is the reason for the description of its refinancing operations as being 'for monetary policy purposes', with Irish ELA therefore regarded as a bad thing because it is not 'for monetary policy purposes'. However, a rise in Irish ELA is automatically accompanied by a fall in refinancing elsewhere, which means there is no overall effect on the euro monetary base. The CBI is merely satisfying its banks' demands for 'liquidity', as it always must if the banks are to remain in business, and it is immaterial whether this lending is classed as 'for monetary policy purposes' or not.

The ECB's monetary instrument is its official interest rate, and the transmission of its interest choices through the banking system is not impaired by the amounts of liquidity supplied by the various NCBs or the ways in which it is supplied.[5] Liquidity support of Irish and Greek banks does not constrain the ECB's ability to raise its official rate as considered necessary to contain inflation.

However, the ECB – or rather the Bundesbank and other NCBs lending through the eurosystem – does have reason to worry about exposure to default risk. Irish and Greek banks are heavy borrowers from the eurosystem because of their exclusion from the interbank market where they are viewed as too great a risk. The other NCBs are therefore taking on this risk.

NCBs lend to their banks using repurchase agreements. But the securities used in these repos are government bonds or lower quality assets, and ELA is explicitly government-backed. Thus the ultimate guarantor of eurosystem loans to Irish banks (via the CBI) is, at best, the Irish government itself, whose debt carries a non-negligible probability of default or 'restructuring'. Irish government (5-year) debt is currently trading at a premium of 7% as compared with Germany.

In the event of Irish – or Greek – sovereign default, it is not clear whether losses would fall on NCBs or on the ECB. But this is of little relevance as the NCBs are the ECB's shareholders and the Bundesbank is both the largest shareholder and the largest eurosystem lender. Losses of the Bundesbank would be for the account of the German treasury.

Thus, eurosystem lending to Ireland is no less vulnerable than EFSF lending: both depend on the creditworthiness of the Irish government. However, while Germany is clearly uncomfortable about underwriting the EFSF, it has not expressed similar concern about its large exposure to Ireland and others through the eurosystem. Perhaps this is because it is powerless to do much about it.

5 If the ECB oversupplies liquidity as it did by means of long-term repos in 2009, the monetary base rises as the excess liquidity is placed in the ECB's deposit facility. However, the ECB's interest policy is then transmitted to the wholesale markets as the rate on the deposit facility.