Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

MACROCOSM

# Saved by an Acronym

Wednesday, November 30, 2011

**Lorcan Roche Kelly**

**Europe's alphabet soup is getting cold. But there's a new recipe cooking.**

There are three standard solutions to the ongoing euro crisis currently on the table. They are all well-known acronyms, and unfortunately they are all getting a bit shop-worn as the crisis drags on:

- The EFSF
- The IMF
- The ECB

This report will be an update on these three acronyms -- but at the end we'll also look at a revolutionary fourth one.

Taking the three in turn, we start with the horse designed by a committee -- that is, the European Financial Stability Facility (EFSF).

- Yesterday's Eurogroup (Euro area finance ministers) meeting -- which also agreed to the disbursement of the next tranche of aid to Ireland, and the long delayed sixth tranche to Greece -- provided the latest update on how the EFSF is now intended to work.
- Sadly, the Eurogroup's update on the EFSF does little more than describe the pre-existing state of play There are still two mechanisms for leveraging the EFSF:
    - Option 1 -- credit enhancement, a partial guarantee attached to new sovereign debt at issue. The rules allow for the guarantee to be detached from the debt after issue and be traded separately. Basically, this is a credit default swap. It is unclear how the EFSF's issuance of such instruments improves market completeness, since they are already widely traded. The EFSF's creditworthiness may be no better than that of existing issuers, especially considering that its guarantees extend to bonds that the EFSF's guarantors themselves have issued.
    - Option 2 -- the Co-Investment Fund (CIF -- another acronym), which will purchase a diversified portfolio of sovereign debt in the primary or secondary market. It will have a three-tier CDO-like structure. A first loss or equity tranche is retained by the EFSF. Investors will buy a senior tranche targeted to a AA rating -- and a participating tranche, which would have a greater

**Update to strategic view**

**EUROPE MACRO, ECB:** Europe is squandering the opportunity to use the considerable institutional resources available -- the EFSF, the IMF and the ECB -- to effectively end the crisis. A new and seemingly radical option is getting some traction -- having individual national central banks use their Emergency Liquidity Assistance (ELA) powers to fund IMF loans to distressed sovereigns.

[Strategy Dashboard home]

Copyright 2011 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

claim on any upside.

- In the sorry tradition of EFSF solutions that have come before (see "On the Europe Summit" October 27, 2011), this one is overly complex and it is still very unclear -- despite promises from the meeting that "extensive discussions with investors" had taken place -- how it will actually work, or who will invest in it. Already, the EFSF is being referred to as the "Enormous Failure to Secure Funds."

So, if the EFSF continues to fail to impress, the Euro area has to look elsewhere for the acronym that will save it. Next in line is the IMF.

- Jean-Claude Juncker, president of the Eurogroup, said at yesterday's press conference that the Eurogroup meeting "agreed to rapidly explore an increase of the resources of the IMF through bilateral loans."
- While the IMF generally funds itself through quota subscriptions, these subscriptions do not create sufficient capacity to bail out a major Euro area economy. In the past, the IMF has increased its lending capacity through bilateral loans -- most notably a $100 billion borrowing agreement with Japan in 2000 -- but, again, the likelihood of the IMF raising sufficient funds for a major Euro bailout from sovereign borrowing is very low in the current climate.

So far, so not very good. The EFSF is ineffective, the IMF is underfunded. Which leaves the ECB.

- European leaders have learned that the best way to get the ECB to *not* do something is to ask it do something. So they have recently started making statements saying how much they respect the independence of the institution in the hope that that the ECB will figure out by itself that it will have to buy Euro area sovereign bonds without sterilization -- that is, engage in quantitative easing.
- The ECB's secondary market bond purchases through the Securities Markets Programme (SMP) already puts it close to the edge of the treaty governing its operations. The cumulative total of these purchases is now over €200 billion, with this week's sterilization operation failing to match the outstanding SMP balance -- it fell short by about €10 billion.
- As a pure credit intervention, the SMP is hobbled by its inability to buy in primary markets and thus fund distressed sovereigns directly. And even in secondary markets its impact has been diminished by its failure to let the market clearly understand its purpose and its scope.
- Despite the whiff of QE from the SMP, it is not QE in the Fed sense. The ECB has -- thus far -- been steadfast in its opposition to QE (see "QE Nein" November 23, 2011), as the political and fiscal discipline -- provided by strong budget rules -- needed to underpin sovereign bond purchases  does not exist in the Euro area -- yet.


**Contact TrendMacro**

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

[About us]


**Recommended Reading**

**The next strategic target: De Gaulle's EU legacy**
Jacob Funk Kirkegaard
VoxEU
November 30, 2011

[Reading home]

- We see this as irrationally squeamish on the ECB's part. It is willing to grant European banks infinite term funding for their own purchases of sovereign bonds -- with that funding secured by the bonds themselves, thus putting the ECB at ultimate risk for them. Yet the ECB will not make the same transaction, or take the same risk, directly.
- This aversion to QE leaves the ECB in a most unhelpful position. It has been too tight all year (see "EUicide" April 7, 2011) -- and its attempts to ease by cutting rates, while welcome (see "On the November ECB Rate Decision" November 3, 2011), won't be sufficiently effective. European banks are so impaired, no interest rate is low enough at this point to spur additional lending.

That said, the ECB, in coordinated action with five other central banks took firm action to increase access to liquidity in the system today. Once again, this shows that the ECB will go to great lengths to ensure the Euro area banking system is as stable as possible. Would that it felt the same way about Euro area sovereigns...

So we have an EFSF that can't, an IMF that can't afford to, and an ECB that won't. That brings us to our fourth acronym -- or actually a pair of them:

- NCB and ELA

National central banks (NCBs) in the Euro area -- such as the Bundesbank or the Bank of Greece -- have the power to engage in Emergency Liquidity Assistance (ELA) -- the provision of liquidity on their own authority, on their own balance sheet, and at their own risk (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011). ELA was deployed during the 2008 global banking crisis, and is being deployed now by four NCBs (see "Europe's New Lenders of Last Resort" November 29, 2011).

- It would be theoretically possible for a NCB in the Euro area to engage in a bilateral loan agreement with the IMF, funding the IMF in order to increase its resources so it can then lend money to a Euro area country.
- There is nothing in the IMF's charter that would stop it engaging in such an arrangement -- in fact the IMF produced a factsheet that outlines how this could be done in 2009.
- The ELA framework that already exists within the Eurosystem means that a NCB could -- as long as a 2/3 majority of the ECB board doesn't vote against the action -- "print" the euros needed for the IMF.

So in the case of Italy, it could work like this:

Italy approaches IMF for funding.

IMF produces a program for Italy for, say €600 billion.

IMF needs €600 billion of funding.

The Bank of Italy makes a bilateral loan to the IMF.

The IMF uses the loan from the BOI to fund its Italy program.

- The reason the IMF would need to be involved at all is because an IMF program would enforce the fiscal discipline needed to make the idea acceptable to Germany. It would be the IMF deciding how the money would be spent, rather than the Italian Treasury, which is presumed to have strong influence over the Bank of Italy.
- This may seem like a crazy idea, but reports suggest that it is being seriously considered.
- Is it likely? Probably not. But that doesn't mean the idea doesn't have power. Indeed, if an NCB actually tried to do this, the potential embarrassment for the ECB of such an overt end-run around its authority could well goad the ECB into the quantitative easing policies it currently resists.

And it shows that, as we've been saying all along, it's not that the Euro area lacks the resources to save itself. The resources, and the institutions to deploy them, definitely exist. They just have to be effectively activated. That's a struggle in Europe, because inherently a 17-member partnership of sovereign states is a massively multiplayer game. At the same time, we think it remains in the interests of Germany and France -- whose long-range ambition is to force much closer economic and political integration across Europe -- to let the ongoing debt crisis drive weaker nations into their embrace.

---

**Bottom line**

Europe is squandering the opportunity to use the considerable institutional resources available -- the EFSF, the IMF and the ECB -- to effectively end the crisis. A new and seemingly radical option is getting some traction -- having individual national central banks use their Emergency Liquidity Assistance (ELA) powers to fund IMF loans to distressed sovereigns.