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Global Economics View

Buying Time for the Euro: A Proposal

- Market stress has risen in many euro area asset and funding markets, engulfing Spain and Italy and raising the risk of a major market melt-down and a banking crisis in the euro area and ultimately euro area-break-up in the absence of decisive policy action.
- EU/EA policymakers need to agree on three items this week to calm markets for the next few months, in our view: i) the full details of a programme to provide liquidity to Greece for at least 12 months, ii) an easing of the terms of EFSF/EFSM (and Greek programme) loans, and iii) allowing the EFSF to purchase sovereign debt in secondary markets, and not just for programme countries.
- ECB support will remain key, as the agreed-upon measures will not be immediately available and the ECB will be the only player with large enough coffers that can move at the speed of crisis.
- Policymakers may yet disappoint again this week as the political hurdles to agreement are high – in that case, expect more market turmoil and more Emergency Summits.
- Further measures to address sovereign and banking sector insolvency issues will still be needed later this year, even if our proposal is fully implemented.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Buying Time for the Euro: A Proposal

Market tensions have increased in euro area assets markets and now engulf Italy and Spain – in response, policymakers have called an Emergency Euro Area Summit on July 21

A comprehensive resolution of the EA sovereign and banking debt crises appears unfeasible in the near term…

…but a feasible option exists that would calm markets for a few months and give policymakers additional time to take more far-reaching measures in the fall

We think the 'stopgap' package needs to contain three elements:

1) **The full details of an additional funding package for Greece**
2) **Maturity extensions and interest rate reductions for EFSF/EFSM loans**
3) **An increase in the size and flexibility of the EFSF, including the right to purchase EA sovereign debt in secondary markets, and not just for 'programme countries'**

Widening market tensions in Italy and Spain have increased the pressure on euro area (EA) governments to act. Although Germany initially aimed to delay a decision on the second Greek bailout program and 'Private Sector Involvement' (PSI) to September, the EA Heads of State and Government will now hold a meeting on Thursday, July 21, with the *"financial stability of the Euro area as a whole and the future financing of the Greek programme"* topping the agenda.

The recent large increases of yields on Spanish and Italian sovereign bonds, and associated convulsions in many other EA asset markets have raised the spectre of a full-blown market melt-down and banking crisis in the euro area as a whole – and not just in the EA periphery. Increased risk perceptions have been driven by a number of factors. Prominent among these, in our view, is the inability of the current official rescue facilities (the EFSF and EFSM) to provide adequate liquidity support to the Italian and Spanish sovereigns, should they lose market access. Markets seem to have concluded for now that EA policymakers have been either unable or unwilling (or both) to agree on more appropriate measures to provide liquidity support to the Italian and Spanish sovereigns or solvency support to help to address the periphery country sovereign and banking sector insolvency crises. Based on the perception that euro area policymakers only act more decisively when confronted by a prospect of an immediate systemic crisis, markets have delivered just that: Without substantial additional policy measures, the risk of a major financial crisis in the European Union (EU) over the summer has risen markedly, in our view.

A comprehensive agreement to resolve the unresolved issues in the sovereign and banking sectors in the EA appears unfeasible before the summer break. In our view, a comprehensive package would include special resolution regimes for banks in EA member states and the EA as a whole, an orderly debt restructuring mechanism for sovereigns and a much larger (€2 trillion) liquidity facility for EA sovereigns. Once these measures are in place, we would continue to advocate an orderly debt restructuring of insolvent sovereigns (Greece, Portugal and Ireland, in our view), including large face value reductions of the outstanding debt, and of insolvent banks in the entire EA to restore the EA to a sustainable fiscal and financial footing. But in the absence of the above-mentioned measures and in the present stressed conditions in many EA funding and asset markets, we do not currently propose any major (or coercive) measures of bank debt and sovereign debt restructuring in the EA periphery.

However, we believe that an agreement at the upcoming EU Summit, that is likely sufficient to prevent a major crisis over the summer and that prepares the ground for more substantial and comprehensive further policy actions later in the year, *is* feasible. In our view, the near-term response required to calm markets should contain the following three ingredients:

- First, it would need to include the full details of measures to provide funding to the Greek sovereign for at least the next 12 months. These measures should satisfy any political need and longer-term financial stability need for private sector involvement. They should also ensure continued funding for the Greek banking system. As the Greek banking system is funded almost exclusively from a shrinking deposit base and by the ECB/Eurosystem, the form of PSI chosen has to be acceptable to the ECB as well.

- Second, the package should include changes to the Troika bail-out agreements (the existing ones and any future ones) that facilitate quick and substantial liquidity provision without aggravating the solvency situation of the respective sovereigns. This means significant maturity extensions and substantial interest rate reductions for programme loans.

- Third, the measures need to include an expansion of the scale and scope of the available liquidity facilities and an increase in their flexibility to safeguard large, potentially illiquid, but not manifestly insolvent sovereigns. Although part of this enhanced liquidity support could be provided by a larger and more flexible EFSF, the active support from the ECB through a re-opening of its Securities Markets Programme (SMP) is also required.

The prospect of a major crisis has increased the room for policymakers to find agreement, but they may yet disappoint again on Thursday

The recent market turmoil has raised policymakers' levels of concern. Explicit warnings (e.g. by German Finance Minister Schäuble) that the crisis now endangers "*the euro as a whole*" suggest that the willingness of EA policymakers, particularly in donor countries, to accept more far-reaching measures than a couple of weeks or even days ago, has increased. We therefore believe that there is at least a chance that the outcome of the Thursday Summit – which the euro area leaders will in any case be likely to announce as a "*comprehensiv*e package" – will be substantial enough to tame markets for a few months. However, policymakers may yet again fail to deliver even the minimum dose required to calm markets on Thursday, raising the prospect of further increases in market volatility and yet another summit in the near future. What is more, the package we hope for would still not be sufficient to comprehensively address the solvency and liquidity problems of the sovereign and banking sectors in the EA. Even were it to be delivered, further action would still be needed later in 3Q.

A plan to tide the EA over for the summer

We present a proposal that contains three elements and that we consider both politically feasible and substantial enough to improve market conditions for at least a few months

A comprehensive resolution of the problems of the EA appears unfeasible in the near term. The sovereign and banking crises are too deep. In the EA donor countries there are too many domestic political constraints on effective action; the national interests of donor countries and beneficiary countries in the EA diverge too much; there is a ongoing conflict of interest between existing private creditors of sovereigns and banks and potential future official creditors; and among the official creditors there is a sharp conflict between the fiscal authorities of the EA donor countries and the ECB about which institutions will incur the direct official exposure to potentially insolvent sovereigns and banks: the EFSF/EFSM or the ECB/Eurosystem. However, the current environment of more intense market pressure has likely increased the room for the national governments to agree on measures to prevent a financial market meltdown (and eventually even a potential break-up of the EA). In our view, there exists a package that, while ambitious by the recent standards of progress in the political area of the EA, has a chance both to improve market conditions enough to tide the EA over for a few months and to be agreed on at the EA Emergency Summit. This package should include three main elements.

1) The full details of an additional funding package for Greece

1. Full details of the second bailout package for Greece including sufficient PSI

The Greek sovereign faces likely funding gap of at least €135bn by mid-2014 – additional funding for at least the next 12 months needs to be found for IMF to pay out September tranche of bail-out loan

Despite the existing IMF/EU bail-out programme, the Greek sovereign still faces a funding gap in the near term, as the projections of the original bailout agreement proved to be far too optimistic in many respects, as we had expected at the time. According to the calculations of the Troika, the second programme has to fill a funding gap of €70bn up to mid-2013 and €104bn up to mid-2014.[1] According to our calculations, the Greek funding gap is likely even higher, between €85bn to €100bn

[1] Greece: Fourth Review Under the Stand-By Arrangement and Request for Modification and Waiver of Applicability of Performance Criteria, July 2011, IMF Country Report No. 11/175

up to mid-2013, depending on the success of the privatization programme, and between €135bn and €167bn up to mid-2014.[2]

Agreement on further funding of the Greek sovereign is needed urgently, for at least two reasons. First, continued funding by the IMF (including payment of the next IMF tranche in September) is conditional on sufficient funding being available for at least the following 12 months. This requirement was waived in June-July 2011, but is unlikely to be waived a second time. Second, there is a chance of a funding gap for the Greek sovereign as early as Q3, if privatisation revenues or reductions in the Greek budget deficit fall short of the programme targets.

An additional funding package requires private sector involvement (PSI) to:

- **be politically acceptable to donor countries**
- **prevent future moral hazard in (private) lending and investing decisions**

Many proposals for PSI exist

Further financing of the Greek sovereign is politically highly controversial in a number of creditor countries, notably Germany, Finland, the Netherlands and Slovakia. To avert the risk of permanently bailing out the private sector creditors of the Greek sovereign with public funds, these countries have pushed for involvement of the private sector or private sector 'burden sharing', a demand that they are unlikely to drop in the upcoming negotiations. PSI is also highly desirable from the point of view of minimising moral hazard and reducing the risk and severity of future financial crises caused by excessive and excessively concentrated lending to banks and sovereigns motivated by an implicit bailout guarantee. There are many different proposals for PSI, including buybacks, a voluntary roll-over of selected bonds proposed by the French banking association, a bond swap into bonds with longer-term maturity suggested by the German Finance Ministry or a tax on all EA banks. In addition to satisfying political demands in donor countries, any viable agreement needs to obtain the ECB's stamp of approval in order to reduce the risk of a violent market reaction.

We propose a phased buyback of Greek government bonds at market prices (but at large discounts to face value) and conditional on compliance with the Troika programme which would:

- **retain incentives for Greece and other peripherals to engage in austerity and structural reform**
- **reduce the debt burden of the Greek sovereign**
- **generate some liquidity over time**
- **not trigger a 'credit event' and may not trigger a 'default' rating**

In our view, a phased buyback programme of Greek sovereign debt at market prices, but at heavy discounts to face value and funded by EFSF loans, is a promising option. The buyback should be phased over several years, with later stages made conditional on compliance with the austerity and structural measures in the Troika programme.

Such a phased buyback programme would not let Greece 'off the hook' completely, as it should be made conditional on continued compliance with the austerity measures and structural programs agreed upon with the Troika.

If the buyback took place at market values and was structured as a voluntary tender, it is possible – but taking into account Moody's default criteria, definitely not certain – that such a buyback would not trigger a 'selective default' assessment of the Greek sovereign by the rating agencies, addressing the warnings by the ECB that it would no longer accept 'default'-rated securities as collateral in its lending operations.[3] It could also avoid being labeled a credit event (triggering Greek

[2] Citi: Euro Weekly: How Comprehensive Can Ad-Hoc Be?, 15 July, 2011

[3] We do not expect that the ECB/ Eurosystem will stop providing funding with Greek sovereign debt or Greek sovereign-guaranteed debt as collateral. There are some options for the ECB to more or less save face in light of an apparent about-turn. One option, suggested in a Reuters report on July 19, could potentially be for the EFSF to provide guarantees for some Greek sovereign debt securities which the ECB would then accept as collateral. Alternatively, the ECB might allow the National Bank of Greece to provide liquidity through Emergency Liquidity Assistance (ELA) or simply continue to provide liquidity based on default-rated Greek sovereign collateral, appealing to an exceptional or emergency need for support of the EA financial system, based on the ECB's financial stability mandate. It is important to note that the ECB has room to continue to accept Greek collateral in its own operations even in the event of a 'selective default' assessment. The ECB's only statutory/Treaty obligation is to provide lending against 'adequate' collateral, with the adequacy to be defined by the ECB itself – there is no explicit or implicit obligation to reject default-rated collateral. Related to this point, we consider the ECB's warnings to be mostly a bargaining chip in the 'Game of Chicken'

sovereign CDS) by the Determinations Committee of ISDA. More generally, by preventing (or delaying) a default rating of the Greek sovereign and/or more coercive measures for PSI, the risk of further escalating market stress are relatively contained with this approach.

A buyback at large discounts to face value would improve the solvency of the debtor, but would not generate any additional liquidity in the very near term to plug the immediate funding gap of the Greek sovereign. To reduce the funding gap for Greece between now and mid-2014 substantially, the buyback programme would need to include bonds which mature over the next three years. However, to generate a significant reduction in the face value of the outstanding Greek gross general government debt (standing at €329bn or 142.8% of GDP in December 2010) which is likely to increase to around 167% of GDP in 2011, the buybacks probably would also have to include longer-dated maturities, which trade at much larger discounts.

Taking advantage of the currently large discounts in markets and the immediate reduction in interest payments and debt outstanding would favour a frontloading of a large part of the buy-backs. However, a more phased buyback programme would substantially reduce the EFSF's near-term funding needs (relative to the frontloaded scheme) for the buy-backs and would maintain the incentives for Greece to continue to implement the programme measures in the future.

Based on an average bond price of 60 cents to the dollar, a debt reduction by €30bn would require EFSF funding of €45bn or quarterly purchases of €3.75bn until mid-2014

The size of any proposed buyback programme is highly uncertain. If the target is to generate PSI of around €30bn (as mentioned repeatedly in the press) and we define PSI as the difference between the price of the purchased bonds relative to the issuance price (par value) of the bonds, the Greek buyback programme would require funding from the EFSF of €45bn on top of the loans for the funding programme, assuming an average price of the bonds of around 60 (this is about the average of current market prices for Greek sovereign bonds between 1 and 30-year maturity).[4] In the case of an even distribution of purchases over the duration of the programme up to mid-2014 (12 quarters), this would imply quarterly purchases worth €3.75bn that would have to be provided by the EFSF. These amounts are well within the lending capacity of the EFSF, even before its proposed increase.

2. Changes to the terms of EFSF/EFSM programme loans

2) Changes to the terms of EFSF/EFSM programme loans

We also propose an extension of the maturities of EFSF/EFSM loans from 7.5 years to 30 years and a substantial reduction in the interest rates charged

Some form of maturity extension and interest rate reductions is highly likely to be agreed upon on July 21, in our view

We propose a maturity extension of EFSF/EFSM loans (and of the bilateral loans in the existing Greek package) from the current average of 7.5 years to around 30 years, to reduce the liquidity needs of the sovereigns in the near future. In addition, we propose an elimination of the interest surcharge over the swap rates for the relevant maturities (from current surcharges of 200bp for Greece and Portugal and 300bps for Ireland). The elimination of the surcharges will be partly offset through higher swap rates for the longer-dated bonds, but would still lead to a sizable reduction in debt servicing costs. The new interest rate for the EFSF/EFSM loans would be around 3.8%, down from a current interest rate of around 4.8% in the case of Greece and Portugal and around 5.8% for Ireland. This would reduce interest payments per annum (when all loans of the current rescue programmes are disbursed) by €1.2bn (0.8% of GDP) in Ireland and €1bn (0.6% of GDP) in Portugal.

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between the ECB and National Treasuries over the distribution of balance sheet risk arising from liquidity and solvency support for EA sovereigns and banking systems. An acceptance of a greater share of this risk by National Treasuries, as our proposal suggests, should make it easier for the ECB to drop its threat. It is also noteworthy that the ECB operates a 'first-best' rule when it comes to assessing collateral which implies that only the highest of the ratings by any of four rating agencies (S&P, Fitch, Moody's and DBRS) is taken into account.

[4] However, it cannot be ruled out that alternatively either the market value of the purchased bonds or even the par value of the involved assets will be used as the measure of PSI by EA policymakers.

If we assume that the interest rates for the bilateral loans provided for Greece will be reduced as well, interest payments of the Greek sovereign would be reduced by €1.6bn (0.7% of GDP) for the first Greek package. In case of Greece the impact of reduced EFSF loan rates would at least double once the second programme would be in place. The terms of the IMF loans for the programmes would presumably remain unchanged.

On July 11, the Eurogroup announced that it stands ready to extend the maturities and reduce the interest rates charged by the EFSF (and most likely by the EFSM as well). We therefore consider a substantial change in the terms of EFSF/EFSM loans – if not necessarily exactly to the terms we propose here – to be likely to be announced on Thursday, despite the fact that such 'subsidised' loans are quite a 'hard sell' in many donor countries.

3. Enhanced liquidity provision, including for countries without IMF programmes (Italy and Spain)

3) Enhanced liquidity provision, including for countries without IMF programmes

Current EFSF is not large enough to cover the multi-year liquidity needs of Spain or Italy, even after the proposed increase to €780bn of guarantees/lending capacity of €440bn

The current size of the IMF/EFSF/EFSM facilities is sufficient to provide multi-year liquidity for Portugal, Ireland and Greece, and a substantial bond buyback for Greece. However, the facilities are likely inadequate to provide multi-year liquidity for Italy, let alone a combination of Spain and Italy.[5] In addition, the EFSF can currently provide loans only to countries under an EU/IMF programme. The proposed amendments of the EFSF rules are scheduled to be implemented in September by national parliaments. But these amendments – an increase in total guarantees by EA member countries for EFSF borrowing from €440bn currently to €780bn, which implies an increase in the EFSF lending capacity from around €255bn to €440bn, and giving the EFSF the right to purchase assets in the primary markets for countries that are already under a programme – are insufficient. To prevent the spreading of the crisis from the manifestly insolvent countries to other countries, notably the 'soft core' of Spain and Italy, we believe it is necessary to provide a large and flexible backstop of financing assistance for sovereigns deemed solvent and not necessarily in need of a Troika programme.

We propose increasing the EFSF and giving it the right to purchase EA sovereign debt in secondary markets, not only for programme countries

These two changes should:

- **allow policymakers to draw a line between Italy and Spain and the insolvent periphery (Greece, Ireland and Portugal)**
- **increase the willingness of the ECB to provide continued liquidity support through reopening the SMP and funding periphery banking systems**

We propose the following changes. First, the EFSF should be given the right to purchase bonds in the secondary market as well, and for countries that are not under a formal programme – which according to the EFSF framework can only be set up in combination with the IMF. In addition, the EFSF should be further increased. The political difficulty of implementing an explicit increase could be circumvented by agreeing to make the €780bn guarantee ceiling 'soft', i.e. change the wording of the proposed amendment to the "guarantees to the EFSF will increase to €780bn and can be extended in exceptional circumstances" without the need for national/ parliamentary ratification.

Allowing the EFSF to provide support for non-programme countries, such as Italy and Spain, has several advantages. First, Italy and Spain are unlikely to sign up to an IMF program until they are left with no other choice. Second, not pushing Italy and Spain into a facility would allow policymakers to draw a distinction between these two sovereigns and the – in our view – manifestly insolvent, sovereigns (Greece, Portugal and Ireland). Third, putting into place further support measures –

[5] After accounting for the present sizes of the rescue packages for Portugal, Ireland and Greece, assuming that the IMF continues to provide one-third of the rescue loans and assuming a contribution of €85bn from these facilities for the second Greek package, around €250bn would remain, rising to around €530bn if the earlier proposed EFSF increase is included. The value of maturing national and regional debt between 2011 to 2014 in combination with our deficit projections suggests that the gross funding requirements of the Italian general government are around €850bn alone in the next three years and those of the Spanish general government around €500bn.

for which the associated credit risk is explicitly for the account of the EA fiscal authorities – will probably make it easier for the ECB to provide continued support. Through the ECB's exposure to Greece, Ireland and Portugal in the SMP, and through its lending to periphery banks, the ECB has already been forced into quasi-fiscal actions on a scale and in a manner that it considers highly undesirable.

Funding for 'non-programme' countries could be made conditional on a commitment to take structural and austerity measures outside of a full Troika programme

There are also other considerations that limit the ability and willingness to increase member state guarantees as well as their effectiveness. To obtain a AAA rating for the EFSF, the rating agencies only accept the guarantees of the six AAA-rated EA member countries (Germany, France, Netherlands, Austria, Finland and Luxembourg).[6] An increase in the lending capacity of the EFSF to, say, €1 trillion, would therefore require guarantees from the core countries of €1 trillion. In that case, Germany would have to provide guarantees of around €467bn (18% of GDP) which, once the EFSF has in fact lent out those funds, would increase Germany's general government gross debt to GDP ratio by the same amount (which stood at 83.2% in 2010).[7] In the case of France, EFSF loan guarantees of €351bn would, should the loans all be made, lift the general government gross debt to GDP ratio up to 101.5% (based on the 2010 ratio of 81.6% of GDP). Hence, any substantial increase of the size of the EFSF would be likely to lead to downgrades of at least some of the remaining AAA-rated EA sovereigns, with the French one likely the first to be affected. As a consequence, the EFSF itself is likely to lose its AAA-rating, which will likely increase its funding costs.

ECB support will remain key for the foreseeable future even if our measures are taken, as:

- it is the only institution with deep enough coffers that can move at the speed of crises

- the increased and more flexible facilities will only be available with a (hopefully short) delay

- large increases in EFSF debt issuance may result in downgrades of one or more of the remaining AAA-rated EA sovereigns

The involvement of the ECB is key in our proposal. Even with the implementation of our proposals, the ECB would remain for the foreseeable future the only institution that can move at crisis speed and size to prevent full-blown market melt-downs.

The ECB might also be willing to accept a share of the burden by purchasing bonds of the not-prima-facie-insolvent EA sovereigns with liquidity problems to limit the increase in EFSF resources that needs to be deployed. This could prevent one or more further downgrades of EA donor sovereigns. The ECB already has the power to provide liquidity to constrained EA countries through its Securities Markets Programme (SMP) under which it can purchase private and public debt securities outright. However, it has not used this facility since the end of March, when the Heads of State and Government decided – against the advice of the ECB – not to give the EFSF the right to purchase bonds in the secondary market. Getting the ECB on board is key for crisis mitigation, which underpins our proposal for the Heads of State and Government belatedly to follow the ECB's advice and allow secondary market purchases by the EFSF and/or also to refrain from taking any action that results in a 'selective default' assessment by the rating agencies for Greek bonds.

We would then expect the ECB to be willing to act more co-operatively. In the final analysis, we believe that the ECB will be unable to resist coming to the rescue of the Spanish and Italian sovereigns, if nothing except the resources of the ECB are seen to hold off disorderly sovereign defaults and an EU-wide banking crisis. This was what happened in May 2010, when the SMP was created and first used because the ESFS was not yet operational.

[6] Citi: Global Economics View: The Debt of Nations, 7 January, 2011

[7] These calculations are based on a decision by Eurostat which stated that the non-EFSF general government gross debt of any EA member state will be increased by the amount of EFSF debt issuance multiplied by the effective EFSF capital share of the respective member state. Net debt would be unaffected, as a financial asset of the same size would also be recorded.

Further substantial intervention by the ECB should not endanger its fundamental solvency or put its price stability mandate at risk

Further intervention by the ECB will add to the size and riskiness of the ECB's balance sheet. However, as we described last year, the non-inflationary loss absorption capacity of the ECB is at least €2 trillion, so even much-increased intervention by the ECB should not endanger its fundamental solvency or put its price stability mandate at risk.[8] The ECB's cooperation will be required when the funding provided by the EFSF nears its capacity, but the ECB's support – or at least its unmistakable willingness to support – is probably also required immediately after the announcement of the Thursday Summit package. Even if the EA leaders agree on all three points mentioned above, none of these measures will be immediately operational, as changing the scale and scope of the EFSF requires national parliamentary approval in all EA member states and a new EFSF programme for Greece in addition requires parliamentary approval at least in Finland (where, unlike in most other EA countries, parliament needs to approve every EFSF package). Should EA policymakers agree to our or equivalent proposals, the ECB may start to purchase Italian or Spanish sovereign bonds as early as Thursday or Friday.

National parliamentarians can be brought back from their summer holidays to expedite the national approval processes for the changes to the EFSF

As some EA parliaments are already on their summer breaks, the logistics of obtaining ratification of Thursday's EA Summit decisions soon will be difficult. But if the national law approval machinery gets to work immediately on Thursday and if national governments call their MPs back from holiday, the ratification process could be completed within one or two weeks.[9] In our view, such a quick approval process is necessary to reduce the uncertainty regarding the implementation of the package and to be able to respond to market developments over the summer. Again, we highlight that obtaining national approval will not be easy, notably in Finland, where Euro-sceptic sentiment has risen as evidenced by the success of the True Finns in the April general election; the Netherlands, where Mark Rutte's centre-right minority government relies on the support of the Euro-sceptic PVV; Germany, where Angela Merkel's coalition partner FDP and CSU and some members of her own CDU party are less inclined to support further agreements than the opposition SPD; and Slovakia, where the approval of the original version of the EFSF was very difficult.

It is time to act – now and in the future

Our proposal contains both concessions from and concessions to the core EA donor countries and therefore has a reasonable chance of approval on Thursday

In our view, our proposal – three policy measures to be agreed by the Heads of State and Government coupled with ECB support through SMP purchases – offers a good chance of reversing the recent surge in bond yields in Spain and Italy and calming markets for some time. It would require significant concessions from the core EA countries but it also includes substantial parts of their demands, such as PSI and continuing the existing conditionality for programme countries. It also does not include common EA or EU bonds ('E-bonds'), which seem to be a line in the sand at least for the current German government. We therefore consider our proposal to be an ambitious, but ultimately realistic, option to find agreement on Thursday.

Implementation of our proposal will not put end the EA sovereign and banking crisis – EA bank and sovereign solvency issues still need to be addressed

Our proposal, however, would not be enough to put an end to the sovereign and banking crises. To solve the fundamental issues at the heart of the EA crisis, solvency – not just liquidity – concerns need to be addressed at the sovereign (in the periphery) and banking sector (in the periphery and in the core) sector level. Only such measures are likely to have a lasting stabilising impact on markets (we have written previously about the measures necessary for crisis resolution[10]).

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[8] Global Economics View: Games of 'Chicken' Between Monetary and Fiscal Authority: Who Will Control the Deep Pockets of the Central Bank?, 21 June, 2010

[9] At least in Germany an interruption of the summer break of parliament is not unprecedented. On August 26, 2009, MPs were called in to decide on the amended version of the Lisbon Treaty.

[10] Citi: Global Economics View: The Debt of Nations, 7 January, 2011

Among these could be a significantly larger size of the phased buybacks in Greece and an extension of phased bond buybacks to Portugal and Ireland, to gradually reduce the non-sustainable general government debt levels in these countries, or an orderly restructuring of the debt of these countries using other methods. The role of the EFSF could be extended to include its use as an EA-wide recapitalization facility for banks, replacing the national schemes which in many countries are not sufficiently large enough to support the banking sector. Such a European bank recapitalisation facility or 'Euro-TARP', which banks could access without the need for their respective sovereigns to start a formal EFSF loan programme, would presumably also make it easier to finally have rigorous bank stress tests, including applying stress scenarios to sovereign debt holdings in the banks' banking books. Mechanisms for the orderly restructuring of bank and sovereign debt would be integral parts of the solution.

Hence, in contrast to the likely statements of the Heads of State and Governments on Thursday, that the outcome of the negotiations will meet the targets of restoring "*financial stability of the Euro area as a whole and the future financing of the Greek programme",* we expect only a temporary impact on markets. Therefore, policymakers should use the time before market turbulence reappears to agree on measures to resolve the EA sovereign debt and banking crisis.

To prevent future crises, other economic contributors to the crisis, including poor competitiveness and high private sector debts, need to be addressed. In addition, the current crisis has highlighted the inadequacy of the institutional set-up of the euro area to deal with fiscal crises in one or more member states and the current lack of credibility of a no bail-out regime, because of the absence of a credible sovereign default resolution mechanism (SDRM) and credible resolution regimes for banks and other Sifis that are excessively exposed to insolvent sovereigns.

To prevent moral hazard in fiscal arrangements of member states in the future and to make fiscal support by other member states, if and when required, politically feasible without endangering the survival of the EA as a result of 'donor fatigue', there are at least two possible (and not mutually exclusive) routes forward. One is a form of 'transfer Europe' with, as quid pro quo for financial support, a significant loss of national fiscal sovereignty for countries that get into sovereign debt problems and have to be bailed out. Liquidity and solvency support from the E/EA would be forthcoming, but only in exchange for the right of the EU/EA to assume a significant degree of fiscal control over the member state that receives the support, potentially including taking over some direct budgetary responsibilities. A 'limited fiscal Europe' or limited fiscal federalism would likely also be part of the necessary set-up.

The other route is a 'you break it you own it Europe', where both sovereign and bank insolvencies are resolved between the debtor government or the debtor bank and its creditors, without any permanent fiscal support or transfers from other member states or from EU institutions, but with a large liquidity support facility for governments deemed solvent. This would require an effective EU-wide special resolution regime for banks and other Sifis and a strong and independent SDRM which would vet any application by a sovereign for liquidity support and could make sovereign debt restructuring a pre-condition for access to the liquidity facility.

Under both the 'transfer Europe with loss of sovereignty' and the 'you break it you own it Europe' approaches, prevention would be better than cure. Automatic, stronger and more effective sanctions for member states that repeatedly fail to meet fiscal targets are required. These penalties could be financial or a loss of voting rights in the EU/EA.

Appendix A-1

Analyst Certification

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