

[A Critique on the Modest Proposal of Varoufakis & Holland](#)  
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About a year ago Prof. Varoufakis and Prof. Holland presented a proposal to solve Europe's debt crisis. Since then, the so-called Modest Proposal (MP henceforth) has undertaken many revisions. Their claim is that the MP can solve the continent's debt woes without any fiscal transfers or treaty changes. The current flavour of their proposal can be found by clicking on the link <http://yanisvaroufakis.eu/euro-crisis/>. Despite the publicity that the MP has commanded in the press and the relentless marketing efforts of its originators, the MP has not captured the market practitioner's imagination or the banker's acceptance. In this note, we analyse parts of the MP and argue that the non-adoption of the proposal may be due to flaws that many would call, detrimental and fatal to the proposal.

Quick Summary of the MP

The MP consists of three main Policy areas. Here we only review Policy 1, which is called "Stabilising the Sovereign Debt Crisis" mainly because without this so-called stabilization the other two policies become irrelevant. Policy 2 and 3 are "Tackling the banking sector crisis" and "European recover Programme". So, what are the main points of Policy 1?

- 1) Eurozone nations transfer a portion of their debt (60% of GDP also called the Maastricht debt) to the ECB. Note that the ECB does not buy the bonds.
- 2) The ECB issues bonds (called e-bonds) which are ECB's sole liability.
- 3) The countries continue to service their debt but at the lower rate that the ECB has achieved in the market rather than the high rates some heavily indebted sovereigns need to pay now.

The authors further argue that the implementation of the MP would stabilise the Eurozone debt crisis without any Fiscal transfers, Change of treaties and no tax payers funded bond buy-backs.

In step (1) there is a tranche transfer of the bonds from the Eurozone countries to the ECB by, say, book entry. The ECB does not buy directly the bonds and the authors of the MP argue that this is structured in order to bypass the no-bailout clause and possibly the printing of money that may need treaty changes. Instead, there is going to be an exchange (swap) of payments. The ECB would pay the interest and service these Eurozone bonds by issuing its own bond (step 2) the so named e-bonds. The Eurozone countries then would pay the lower funding that the ECB has achieved by issuing its own bonds (step 3). These e-bonds could possibly be bonds or short term T-bills.

The strategy sounds simple but there are hidden assumptions and also fundamental policy problems with the whole idea. I would start the analysis with a small diversion to explain the market practice of Special Investment Vehicles or SIVs. Originally, it was used by banks to bypass restrictive laws

and regulations and also to increase profits in a tax efficient way (euphemism for legal tax-avoidance).

*Diversification Start:*

**SIVing your Assets**

The SIV process has many uses; the main ones were, to go round regulations, capital requirements and funding. Most of the time it was done with the tacit approval of the regulators, at the insistence of their political masters, who did not want to upset their cosy equilibrium. The changes in the Basle rules for banks did not tackle the issue effectively. This practice significantly contributed to the credit crunch and the global crisis. At the height of the bubble years, banks engaged in it en masse. Here is how it works.

Banks would move billions (possibly trillions) of assets from their balance sheet by selling them to an offshore Special Investment Vehicle (SIV). Let us call this Special Investment Vehicle, ACME. You may ask how ACME is going to buy these assets. Where is it going to find the money? It is simple; ACME would borrow the required money from the market. The phantom directors (offshore company) of ACME would fund the purchases of these assets by issuing bonds and short term commercial paper to the market. Why would the market give its cash to buy the ACME paper? Because investors assumed that ACME's commercial paper<sup>1</sup> are backed by real, secure and performing assets.

Why did the banks do that? Well, for some time, the main reason was to bypass the local bank regulation and regulators which prohibit the Banks from taking undue leverage and also for funding. By selling them to ACME (true sale) and thus reducing their assets they achieved this goal of bypassing the legal restrictions. Next ACME would fund these assets at a much lower rate since their bonds and commercial paper was backed by assets and a credit rating of AAA was given by the rating agencies to these bond issues or Commercial Paper. ACME also used short term funding, thus reducing the cost even further<sup>2</sup>. More importantly, ACME would have an *unlimited liquidity commitment* from the mother Bank (some had limited liquidity commitments but many had unlimited) in case it was not able to raise the required cash in the market.

If that sounds a too good to be true strategy for the banks doing it, it is because it is too good to be true. This is what went wrong.

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<sup>1</sup> Commercial Paper is a kind of a bond with very short maturity, usually 27 weeks or less but always less than a year.

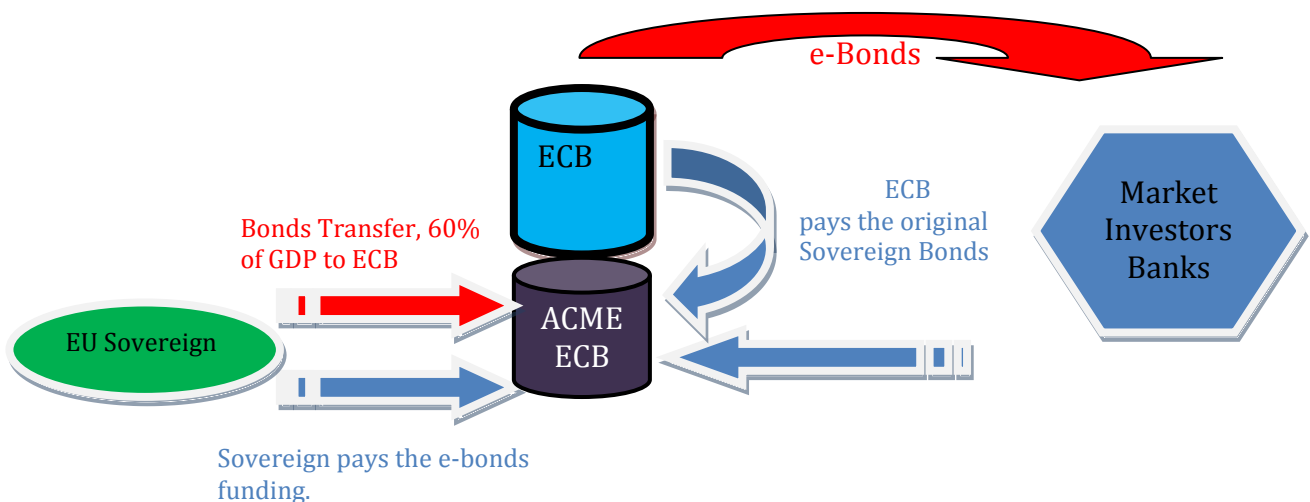
<sup>2</sup> Most of the assets that were moved were long dated so funding them with the lower rate short dated commercial paper can achieve boosts profits.

When the assets that were held by ACME started defaulting or deteriorating in value (became non-performing), the market refused to buy ACME's paper. Fears of the underlying collateral stopped investor giving money to ACME. What happens next is going to be a case study for business schools for many-many years to come. ACME activated the unlimited liquidity commitment (this is a Credit Facility) that they had with their mother bank and asked for hundreds of billions to be given in order to fund these assets. The banks panicked; they had to find hundred billions up to few trillions of dollars and Euros in just few hours or days. The interbank market froze completely. This is when the central banks intervened and opened the taps for the banks. The global credit crunch was in full swing.

Incidentally, the SIVs like ACME are part of what is called "shadow banking system". Namely, companies which are neither regulated by any competent authority nor have any access to central banking facilities, but at the same time behave like a bank and can blow up the normal banking system with a sneeze.

*Diversion end.*

Now let us look at the MP again. The bonds of the Eurozone's member states would be transferred to the ECB. How much is that. Assuming, as the MP recommends, 60% of the GDP, the so called Maastricht compliant debt this amounts to roughly 7trillion Euros. The average maturity of these bonds is not known (can be calculated) but a good guess-estimate would be around 5 years. So again, heuristically thinking, the ECB would have to fund close to 1.4trillion a year. This, the ECB would do by issuing bonds and short term T-bills into the market. All this time the sovereigns would service their debt if they can at the rate achieved by the e-bonds.



Effectively, the ECB becomes our ACME-ECB Special Investment Vehicle. The difference is that ACME-ECB does not buy the bonds outright but it assumes the servicing of them. So ACME-ECB takes all the credit risk. It is implicitly

#### Article 104

1. Overdraft facilities or any other type of credit facility with the ECB or with the central banks of the Member states (hereinafter referred to as 'national central banks.') in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments.

selling protection to the holders of these bonds. It is not clear from the MP whether the bond holders pay for this protection or it comes as a freebie by the ECB. The MP Tranche transfer is done in order to bypass the No-Bailout clause (Treaty article 104. See box on the left) that prohibits the purchase of Bonds. So what happens if, as in the case of the original ACME, the government bonds start underperforming or even the sovereign stops servicing them? Does ACME-ECB have an unlimited liquidity commitment with the Eurozone countries? *The hidden assumption of the MP is that since it is a central bank, it has its own!* In the event that the

sovereign cannot make any payments the ACME-ECB would make up the shortfall for it. This would be done by printing new money or perhaps by the sovereign pawning some assets with the ECB (giving collateral).

#### **Overdraft Facility not allowed by Article 104**

What I have just described is called an overdraft facility. If the sovereign is not able to fulfil its financial commitments the ECB offers a credit facility or an overdraft facility until the country in question recovers. Article 104 (see side box) explicitly prohibits not only the buying of government bonds but overdraft and credit facilities too. Based on this evidence, the assertion in the MP that there is no need for change of treaties should be re-examined and possibly changed.

#### **e-Bonds fail to sell?**

Is it possible that the market would not buy the ACME-ECB bonds? Under what conditions can the market shun the ACME-ECB bonds? This is another of the hidden assumptions of the MP proposal. The MP assumes that the ACME-ECB would always be able to raise cash in the market at much lower rates than anyone else. The recent failure of the ECB to sterilise the Securities Markets Program (SMP) despite more than 200billion of excess liquidity in the banking system paints a different picture. The market could only buy these bonds at cheaper levels if there is an ultimate backstop. Credit guarantees are not adequate (For more on this see <http://andreaskoutras.blogspot.com/2011/10/leveraging-efsf.html>) as there is very high correlation between the guarantor and the beneficiary (similar to someone selling life insurance against himself dying; once he is dead you cannot get any insurance money from him). We have an example of this. The EFSF is a joined guarantee vehicle and the market is not convinced. It currently prices the EFSF bonds at 200 basis points above the German bonds.

#### **ECB's Independence is in peril if Credit guarantees are given.**

Furthermore, the ECB by construction is an independent institution of the EU and any credit guarantees given by member state on its balance sheet would severely impede on ECB's independence. The last point is not merely an

academic one but strikes at the core of the Treaty of the Union and is a fundamental one. In order to reduce the independence of the ECB one needs a fundamental change of the TEU and the articles referring to the ECB.

Thus, contrary to the MP's assumption, the market does not need to comply. If this happens, ACME-ECB would have to somehow cover the losses or else go bankrupt. The ECB as a bank has equity of 10.8 billion Euros and so it cannot take the serious losses that the ACME-ECB would incur in our scenario.

### **Countries take the losses (taxpayers)?**

The only other option is of course for the ECB to start printing the cash to cover the losses. ACME-ECB could be allowed to print money and thus make the fiscal transfer to save the country's bonds in default and in the process save itself. Incidentally, this is exactly the reason why the ECB is not participating in the Greek PSI that requires 50% haircut or close to 12 billion losses for the ECB.

Finally the other option is for the ECB to ask for the surplus countries to pay up the difference, thus effectively charge the taxpayer of these countries. Whichever way you look at it then, a treaty change is inevitable for the MP to proceed.

### **Pretend it is a Liquidity and not Solvency crisis**

If the printing is allowed (with or without treaty changes of article 104) one could argue that since the ACME-ECB keeps on servicing the debt, the country would not default. This of course assumes that the country's crisis is a liquidity crisis and not a solvency crisis.

ACME-ECB could of course pretend that the country in financial peril is sound and solvent and that it only suffers from a short term liquidity problem. As there is no bankruptcy law or procedures for sovereigns and a sovereign does not liquidate and disappear we can all close our eyes and pretend it is solvent. Would the market believe it? If yes for how long before they realise the conjurors sleight of hand? For how long would the country be allowed not to service their account with the ECB?

If that viewpoint is taken then the ACME-ECB merely provides a liquidity facility (albeit by printing) for the country that cannot access the markets. This also entails a huge moral risk for Europe. In other words even countries that are debt prudent would push for profligacy. In any case, the ACME-ECB would have to amortise and absorb the losses for some considerable time (till the country recovers). Would this printing affect the reputation of the ECB and the perception the markets have on the value of the Euro or of Europe's institutions and policies? One can only answer this question positively. Basically it would set the minimum printing of money to 7 trillion which is the Maastricht compliant debt. It would further push every country to assume this amount of debt (60%) for ever. That does not sound a great policy innovation for the future of Europe.

In conclusion, the MP's assumption of no Fiscal transfer and no need to change the treaties can be violated. Furthermore, ACME-ECB would become hostage to the market whims as it tries to fund the trillions needed. I do not believe that this is how most Europeans envisage the role of the ECB or how the Bankers would like to conduct their policy mandate.

### **e-Bonds are not Plain and Boring Bonds**

Another contentious point of the MP is the issuance by the ECB of the so-called e-Bonds. Apart from the issue of price that was analysed earlier on, we also have the issue of what these e-bonds would represent. Assuming that there are no credit guarantees by European countries (see earlier why) what is the e-bond's legal structure and what sort of covenants would guarantee repayment?

The MP is calling for the ECB to issue debt which would service the Eurozone's transferred bonds. Let me briefly describe what a plain boring bond is. It is legal obligation (loan) of a borrower to repay with interest and at specified time the amounts borrowed. The legal contract furthermore specifies how the money borrowed would be spend and from where the borrower is going to generate the cash to repay the creditor. For example, corporates which borrow, declare that their business model of selling stuff would raise the cash to service the interest and repay the loan back to the investor. The "business plan" of sovereigns involves taxing its people and other legal entities in order to raise the required cash in return for services like education, security, health etc.

What exactly is the business plan of the ECB as a borrower? To print cash is not an acceptable business plan for a central bank and neither the bankers nor the people of Europe should want this to be. In fact, ECB has a very specific mandate, that of price stability (inflation) and the stability of the financial system. There is no mention of the ECB as an issuer of debt and how this debt would be repaid. The ECB does make some profit which is distributed to its shareholders (the National Central Banks of Eurozone) but nowhere near the billions that are needed to cover the repayment of the e-bonds, should a sovereign stop paying the e-Bond's coupon.

### **Monetary Policy reversal**

ECB's main mandate is monetary policy. The way the ECB is able to control short term interest rates is through the weekly Open Market Operations. Let me briefly describe how the ECB sets and controls the so called Repo rate which is the short term interest rate. If we look at all the European banks as a whole (called the EUROSISTEM) then we discover that the EUROSISTEM is missing around 450billion of cash. This is done intentionally in order for the ECB to be able to control the supply of money. Banks need cash and they have to go to the central bank (ECB) to borrow it. The ECB then charges them an

interest rate which is called the Repo rate<sup>3</sup>. With the MP however, the ECB becomes a receiver of cash rather than a giver through the e-Bond operation. This represents a reversal of the way monetary policy works and a reversal in the needs and incentive. Now it is the ECB that would need to borrow the money from Europe's investors through the selling of e-bonds. Currently, we do have an example of how this could work. It is the Securities Market Program (SMP) of the ECB. The central bank has bought outright more than 200 billion of peripheral government bonds and it conducts a weekly sterilization operation to withdraw the money from the system. This taking back the money has failed four times already for a variety of reasons. It also means that even if the ECB floods the system with cash through the weekly Repo operation the EUROSYSTEM of banks are not obliged to buy the e-bonds. In this case, the ECB would have to offer much higher rates to entice the banks to buy its e-bonds and in the process create an asymmetric bond market. ECB would turn from a market controller to a market hostage. This could also be seen as a direct subsidy to the investors to buy the e-bonds. Namely, banks would borrow cash from the ECB at say 2% only to give it back to the ECB at a higher rate. This is the ultimate carry trade. It is very doubtful whether this would create a healthy and functioning bond market.

### **Fiscal Policy-Democratic Deficit**

The ECB is an independent institution of the EU. In fact in a comparison between many Central Banks the ECB is amongst the most independent ones. Not even the German Bundesbank had such independence from the German state. The problem however, is that the ECB is also un-accountable. In other words, although it frequently appears in front of the European parliament it is only to inform and not to take orders. The ECB is not directly subject to any form of democratic accountability or influence in its operation<sup>4</sup>. This may not necessarily be a bad thing when it comes to monetary policy but it is certainly not the case if we give the ECB more fiscal responsibilities.

The MP creates a hybrid of an institution. Namely, an institution that combines some of the functions of a central bank and some of what traditionally is called the treasury or the Ministry of Finance. There is a long list of reasons and academic studies why these two functions should be kept separate in a modern state. In the scenario we are examining the ECB would become dependent on the markets for money (very un-central bank) and the sovereign states would become dependent on an un-elected institution and one that is also un-accountable. This is a very serious breach of the democratic values and the European peoples should resist any such proposal.

### **Conclusion**

The Modest Proposal of Varoufakis and Holland suffers from serious defects that inhibit the adoption of the plan as a solution to Europe's debt woes and in many ways they negate it. The claim that there is no need for treaty changes is refuted in most scenarios. Furthermore, the implementation of the

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<sup>3</sup> Banks get the cash through a tender process (auction) but since the crisis erupted the ECB has suspended the auction and instead it offers full allocation of cash if the institution asking has enough acceptable collateral.

<sup>4</sup> With the only exception of foreign exchange where the EU has a saying.

MP would also endanger the ECB as an institution capable of conducting the monetary policy for the Euro. Thus the current form of the MP should be modified if it is to credibly address the European debt problem or abandoned altogether as a proposal.

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**PS: It is possible that I may have overlooked something in my analysis and that the MP is a credible solution. I would be therefore grateful if you have comments or if you think that I have made some grave mistakes in my analysis of the MP.**