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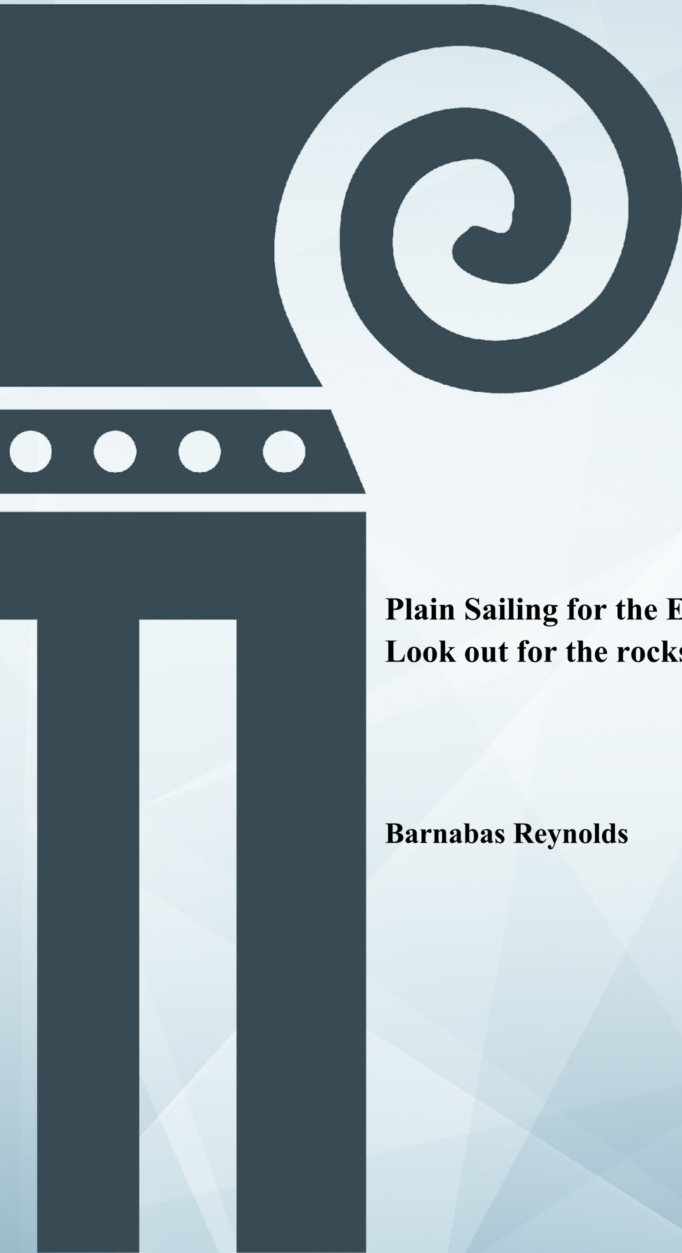

Plain Sailing for the ECB? Look out for the rocks!

Barnabas Reynolds

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Plain Sailing for the ECB?
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The ECB at 25

The European Central Bank recently celebrated its 25th anniversary, but the festivities in the Bank's Frankfurt home may be misplaced. High levels of debt pose serious challenges for the Eurozone and its creditors. Any assessment of the ECB's performance over this time must not only consider that debt, but also the unique framework which gives rise to it. Moreover, steps should be taken to protect the UK outside the Eurozone from the repercussions arising from any future mishaps. "So far so good" is often the commentary, the suggestion being there have at least until now been no disastrous consequences. This is clearly inadequate.

A normal bank?

The ECB portrays itself as a normal central bank. It is tasked with managing interest rates and implementing monetary policy for the Eurozone. It also carries out the other day-to-day functions of a central bank. Its public statements revolve around these tasks, and commentators often see it as successful, implying performance no worse (overall) than the Federal Reserve (in the US) and the Bank of England (in the UK). The Euro is the second most significant currency in the world after the US dollar. The EU has even aspired to make the Euro the world's next reserve currency.

There are of course grumbles amongst member states about the ECB's performance. The ECB sets interest rates at levels that are often too high for the successful states of the northern Eurozone, but too low for the southern states. This over-suppresses inflationary pressures in the north whilst failing to curb inflationary pressures in the south. Yet these complaints are generally seen as entirely natural and inevitable compromises arising from living and operating within a wider zone where individual economies vary significantly.

The disturbing reality

But it is the portrayal of the ECB as a normal central bank, the more mundane picture, that masks something disturbing: the EU's aspirations for the Euro and the ECB run far ahead of reality. That reality is that the legal arrangements underpinning the ECB's operation mean it cannot behave like the Federal Reserve or Bank of England.

The underlying problem is the half-complete legal structures of the Eurozone under which monetary matters are centrally controlled by the ECB, whereas fiscal matters are conducted at a member state level. Member states have relinquished (to the ECB) their ability to control their own central banks, so they can no longer guarantee they will be able to print more money to repay their debts. Instead, they rely on their own tax base, with the limitations inherent in that. The reason for this situation is political: Eurozone member states have so far refused to accept mutual liability and pool significant resources. They wish to have the benefits of a single currency but without creating common liabilities with a common tax base, which makes them differ from the US and UK.

The ECB's mission is far more complex than that of the Federal Reserve or Bank of England, and it is forced to navigate legal and political obstacles unknown to those organisations. In seeking to achieve its goals under EU law, the ECB, under its head, Christine Lagarde, a former lawyer, makes highly delicate and dangerous manoeuvres. One false move, or a series of smaller errors taken together, could destabilise the EU financial system, with serious repercussions for the EU and other economies around the world. Even though the dialogue surrounding the ECB is ostensibly economic, it rests on and often conceals factors which are uniquely politico-legal.

The implications of this unique schism in matters of financial sovereignty are profound.

Breaching international rules – the consequences

The fudge has led the EU to make consequential changes to its law and to take decisions of extreme gravity. The main ways in which the EU has rendered the Eurozone system opaque and unnecessarily risky are discussed here.

1. *Breach of international regulations.* First, the EU has decided to treat the debt issued by Eurozone member states as of sovereign quality within its territory. However, the ability of truly sovereign states to call on their own central bank to repay their debt means that those states need never go bust. Eurozone member states have no such ability. Because of the split in sovereignty between the ECB and member states, member state debt is sub-sovereign, in the same way as US municipalities. Their tax revenues may be insufficient to service their debt, and their creditors run the risk that they are forced to default.

   The implications of this regulatory fib are dangerous. International regulations made by the Basel Committee treat sovereign debt as the bedrock of the financial system, since it is free of credit risk. Given the way in which the Eurozone is constructed, it has no sovereign instrument (except that there is a relatively small amount of recently issued EU debt). Providing sovereign treatment under EU law for what is properly thought of as sub-sovereign debt means that trillions of risky instruments are placed into the EU's financial system without any counterbalance for that risk, as would otherwise arise under the Basel Rules (to which the EU subscribes). Member state banks tend to be major purchasers of the debt issued by their member state, in some cases because there are few or no other buyers. Under EU regulation those banks which purchase those sub-sovereign bonds need not take account of the possibility of default by issuing liabilities that can be written down were these assets to go into default. They are allowed to treat this debt as fully liquid when its market may not exist were sentiment to change. And it can be delivered to the ECB and other EU financial parties at full face value when provided as collateral. This means that the risk arising from this debt is not captured by EU financial regulation, and back-to-back dealings in the market mean that the risk is quickly

dispersed across the EU and the international financial system globally, given the interconnectedness of financial markets and the fact that global banks have in practice to bail out their EU subsidiaries.[1]

2. *Opaque accounting.* Secondly, EU accounting treatments are highly opaque. The result is that participants in the financial markets are barely able to keep track of their true exposures to Eurozone risk. This can be seen in two main ways:

    a. *Breach of debt-GDP ratios.* A forensic analysis of the data as at year end 2021 reveals that the EU's accounts are misleading. Debts of around EUR 6.4 trillion went unrecorded at year end 2021.[2] If those debts are added back in, one can see that the EU itself was operating with debts of 160% of its GDP;[3] German debt was at 102.8 per cent of GDP; French debt at 112.9%; and Italian debt at 222.6 per cent.[4] These are not the reported numbers. The levels of indebtedness are far more acute in the south than the north since the southern states have the benefit of being able to borrow money in the financial markets at rates which would not be possible were they to have their own currency and central bank. This has allowed them to accumulate inordinate amounts of debt. Interestingly, regardless of this distinction, all the debt levels are in breach of the EU's own rules which restrict member state indebtedness to 60 per cent of their GDP.

    Moreover, this indebtedness rest on top of further exposures. The data does not reflect unfunded pension and other arrangements, nor contingent liabilities, including for the Eurozone arrangements themselves. In addition, the true numbers are not reflected in official EU credit ratings. For instance, Germany was

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1 Reynolds, Blake and Lyddon *Managing Euro Risk* (2020) Politeia.

2 Lyddon, *The Shadow Liabilities of EU Member States and the Threat they pose to Global Financial Stability* (2023) The Bruges Group.

3 The assets of EIF and InvestEU are "off balance sheet" from the Eurosystem, allowing for greater levels of debt than the rules agreed by member states might allow for.

4 See Lyddon, *supra.*

quoted as having a 69 per cent debt-GDP ratio at the end of 2021 (which is the figure also relied on by the UK government[5]) as well as a AAA rating from a major rating agency,[6] reflecting a perception of the highest level of creditworthiness.

b. *Banks' non-performing loan (NPL) portfolios.* EU regulations allow banks to treat their NPL portfolios as partially performing, at a percentage which reflects their own assessment of the likelihood of repayment, without any renegotiation of the loan contracts. This is at odds with standard international accounting practice that such loans, when seen as non-performing, should be written off as bad debts.

3. *Financing through the ECB itself.* The ECB's principal tool of monetary policy involves collateralised lending and repo operations, under which the ECB takes as collateral what it defines as high quality public and private sector debt from member states. The loans it makes can be of long-term duration, so that the collateral may never in practice be returned. The ECB has been taking on low-grade ("speculative") illiquid debt,[7] for which there is otherwise little or no market interest, allowing member states and their companies to issue yet more debt, safe in the knowledge that there is a ready buyer. Such practices are in stark contrast to the operations of the Bank of England in terms of the quality of collateral it requires. Some of this Eurozone debt – member state and private sector - is now of extremely poor quality. It is unlikely that such debt would ever be taken back by the private sector, so what might be assumed to be normal monetary operations involving the lending against returnable collateral appears in fact to be a means by which the ECB is financing member states, their financial firms and (indirectly) their companies,

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5 UK government debt and deficit - Office for National Statistics (ons.gov.uk)

6 Standard & Poor.

7 See Lyddon, *supra.* Since the pandemic, the ECB has been accepting debt rated BB. Moreover, credit assessments by a commercial bank are treated as akin to a public rating. The ECB is meanwhile treating itself as running little risk: the capital cushion at year end 2021 was 1.2% of the assets to which it was exposed.

without political acceptance from the northern Eurozone populations over the financing of debts from the south.

4. *The use of EU law to mask the risk.* EU law has developed in a manner which masks the true risks of the Eurozone. For example:

   a. the short selling of member state debt, i.e., trading in a way which profits from a reduction in value of that debt, can be prohibited, and so can the short selling of the debt of Eurozone financial institutions. These rules, when used (as happened across the Eurozone in 2011-12 and, for Greece, in 2015), significantly reduce the ability for the financial markets to take a negative view of the value of the debt, dampening market forces and maintaining the ostensible market value of the debt at artificially high levels.

   b. clearing houses, which sit in the middle of derivatives and certain other transactions, are forced to treat member state debt which they accept, including of those states whose debt trades at a significant spread against the risk-free rate, as sovereign.

   c. the EU's bail-out mechanism for Eurozone member states, the European Stability Mechanism (ESM), is accounted for in a misleading way and is in no position to mount a major Eurozone bailout. It has subscribed capital of EUR 705 billion but only EUR 81 billion of this is paid in. The remainder is a claim on member states to inject fresh funds. Only EUR 81 billion should appear on the ESM balance sheet.[8] Furthermore, the balance sheet carries EUR 58 billion of "cash in hand, with central banks and post office banks" and a further EUR 11 billion of "loans and advances to credit institutions". Contrary to what is implied by this terminology, these are not liquid, high-quality treasury

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8 The European Investment Bank, whose capital structure is similar, correctly nets its unpaid capital of €227 billion off against its subscribed capital of €247 billion on the liabilities side of its balance sheet without claiming the existence of any related asset.

assets, but are low-quality and less liquid bailout programme assets.[9]

5. *Breaching World Trade Organisation (WTO) standards for trade.* Finally, it appears that trade from the northern Eurozone, the (short-term) beneficiary of these arrangements, is in breach of WTO rules which prohibit unfair dumping of goods at artificially low prices, and unfair subsidisation. Both unfair dumping and subsidisation arise for goods from those states as a result of: their artificially low currency level; subsidisation of buyers from sellers in that region through the Eurozone's TARGET2 payment system; and an artificially cheap banking system (because it is undercapitalised, as explained above).[10] The result is to create trade distortions and unnatural trade dependencies for the UK.

What steps should the UK take?

These issues are of concern to other countries and the global markets. They are of particular concern to the UK. The UK continues to run a direct exposure to the EU, under provisions in the Withdrawal Agreement 2020, to the tune of EUR 200bn.[11] Moreover, there are other displacement effects specifically to the UK's detriment. The UK's debt-GDP ratio at the end of 2021 was the same as Germany's, at 102.8 per cent. Yet Germany's debt was AAA rated by Standard and Poor, and the UK's rating was AA. The UK seems to have been penalised in its perceived creditworthiness and performance relative to the Eurozone and EU.

Against this complex and potentially fraught backdrop, the ECB's functions are anything but normal. Any assessment of the performance of the ECB since its

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9 They are of the same quality and liquidity as "loans and advances to euro area member states" and "debt securities" owned by the Eurozone's defaulters: Greece, Cyprus, Portugal, Ireland and Spain. See Lyddon, *supra.*

10 See Collins, *How to Level the EU's Playing Field – Trade Remedies for a Trade Deal* (2020) Politeia.

11 We are exposed to EUR 159bn through the EU itself, of which only a third has a natural, scheduled run-off date. The rest is either evergreen or, in the case of InvestEU, has equity stakes behind it and guarantees whose end date is unclear (and may not exist). That is on top of EUR 39bn through EIB which, in case of InvestEU, presents the same problems with no run-off date. There is then about EU 1bn through the ECB as well.

birth 25 years ago needs to be tempered by a proper understanding of the dangers of its entire operation. There is a lot to be grateful for. The ECB has managed to avoid (so far) a calamitous collapse which the above debt levels might imply. Nonetheless, any discussion of the ECB's performance cannot be normalised by a superficial comparison with the Federal Reserve and Bank of England. We cannot ignore the implications of the risks of the Eurozone and must now take action to protect ourselves from the untoward seepage of those risks, as follows.

- *Minimise our Eurozone exposures.* Global regulators should consider how to minimise exposures to the Eurozone of the financial firms they supervise, including in light of the opacity of Eurozone accounting. The Bank of England already, uniquely (amongst the main relevant central banks), conducts stress tests which require our banks to hold capital against Eurozone risk;[12] but this is not enough. A "worst case" assumption should be made of exposures to Eurozone financial firms in terms of their Eurozone exposures. The global regulators need to manage that risk, by requiring their financial firms to hedge against these assumed amounts by applying the (Basel and other) capital, collateral and liquidity rules.

- *Reject post-Brexit overtures to move business to the Eurozone.* International financial firms should not be persuaded (by the EU) to conduct meaningful business in the Eurozone. The desire on the part of some Eurozone states to pull financial business into their territories, from the UK and elsewhere, should not be accommodated by the international community. Flawed EU regulation means that EU regulatory supervision is also flawed and cannot be relied upon. Pressure placed on international financial firms by the ECB to "onshore" more personnel and book business in the EU should not be accepted; otherwise the rest of the world shares that risk.[13] Instead, Eurozone and EU customers should be expected to deal directly with non-EU based financial firms, cross-border,

12 See *Managing Euro Risk, supra,* Chapter 7.

13 See *Managing Euro Risk, supra.*

as they are entitled to do by EU law.[14] This is in fact more cost-effective for customers and firms alike, given the benefits of concentrating business in a limited number of legal entities, which can then net down their legal exposures and therefore risk.

- *Remove contractual liability for the consequences of Eurozone risk.* The UK needs urgently to renegotiate or nullify the Withdrawal Agreement provisions which give rise to the EUR 200 billion financial exposure to the Eurozone. Those provisions were negotiated when the UK sought to leave the EU and reflected discussions about those EU liabilities which the UK should accept on its departure. However, the UK has been left with too much exposure to the fortunes of the Eurozone. The Withdrawal Agreement was not a sovereign-to-sovereign arrangement. Under international law, it can and should now be set aside, on the basis it was temporary, and circumstances have changed.[15] The point is that, when those arrangements were entered into, the UK was not in a fully sovereign position, and so they are not valid as an international agreement. New arrangements, appropriate to the UK's sovereign status, should be put in place.

- *Neuter the unfair advantages reaped by the Eurozone from running its system "on the cheap"* . The UK is bearing some of the risk and potential liabilities.

  The UK, US and other states should consider levying countervailing duties at their borders (as they are entitled to do, unilaterally, under WTO rules), on goods from the northern Eurozone, to put the prices of those goods back to what they would be were the unique distortions of the Eurozone to be removed.[16] The arrangements distort trade patterns

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14 See e.g., Reynolds, *Trade's winning Ways – The UK Financial Sector and the EU* (2021) Politeia.

15 This is possible on the basis of the reasoning in the advisory opinion of the International Court of Justice in the case of the Chagos Islands: Legal Consequences of the Separation of the Chagos Archipelago from Mauritius in 1965 (icj-cij.org)

16 See Collins, *supra.*

and create dependencies based on volatile and opaque factors which, if the Eurozone arrangements fell apart, would cause huge disruption and detriment as patterns re-adjusted to normalised trade flows. Taking steps to normalise trade outcomes now would reduce the potential volatility and risk of fallout.

In the meantime, whilst the UK must, with the US, seek to navigate the rocks and monitor the ECB's progress in doing so, we can only hope that the next 25 years of its operations will be as quiet on the surface as the last. Above all this country must work to ensure that any financial ripples can be contained by the ECB, within the territory of the EU, in a way that avoids unrest or worse. The ECB's task is extreme. Congratulations are in order for making it thus far. We can only wish the ECB every success for the future.

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