



The Euro dilemma between liquidity and budget discipline – and both goals could be achieved

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The Euro zone countries have allowed a haircut to Greece which the market has already given.

Obviously the markets are not convinced by this measure. To allow this haircut to full extent, without recovery duties like earn out concepts, does not fix the basic problem of the Euro system, but only temporarily circumvents it. The challenge is to find a solution that enforces spending discipline and assures liquidity for all Euro based countries at the same time. So far the German hardliners believe liquidity hinders discipline, and this assumption is wrong if restructuring comes with covenants and risk adjusted rates.

The decision, therefore, has unfortunately not used the chance to make a financial restructuring that provides incentives and penalties and that sends a clear signal to other deficit states. Now other debts burdened countries could be tempted to follow and see the market discount on their bonds as a potential haircut (which is a great gift at the expense of others). Because new liquidity of the Central Bank is feared as an inflation driver, haircuts are perceived to be the smaller evil. The so called fiscal unity only sounds like a nice word (which is easier to sell at home than transfer union) and not as convincing like a transparent logical mechanism that regulates by a financial unavoidable bonus malus system.

Because haircuts should not hit the tax payer, they must hit the banks and institutions. The banks will get recapitalized but only reluctantly because it dilutes their shareholders. This risk can be mitigated by forced capitalization which costs time and frictions. And this leads automatically to a credit crunch for domestic capex financing which in the long term has damaging consequences.

Europe's 500, the European association for growth companies, is worried that this simplification damages the domestic credit markets and leads to a continuing and endless Euro debate. Europe's 500, therefore, proposes an approach that ensures DISCIPLINE + LIQUIDITY at the same time and thereby improves the growth prospective in Europe.

1. Creditor participation (for banks, institutions and individuals) should be limited to foreign lenders/investors

It is understood by everybody that public debt levels need to be stabilized in order to stabilize markets and trust. On the other hand the reliability of government actions and promises to their own citizens is fundamental, otherwise governments lose authority and efficiency with the result that grey and black markets may boom. A state that doesn't honor the debts to his own citizens, will lose all support from within and will be seen as stealing from his people.

Instead of asking creditor participation from everyone for government bond risks, this risk should be limited to foreign investors who want to benefit from higher interests than in their own countries.

Citizens and regional institutions that invest in their own government bond, should be protected by a government guaranty of 100 percent of the nominal claim. This will also offer an incentive to the population, e.g. in Greece, to lend to their own states. So the same people that benefit from the state's support system, finance it. These people also co-own the theoretical collateral behind the bonds, which is the public infrastructure built in their country and in their favour.

If you consolidate the state and the private sector, the receivables and liabilities set off within the country (because the people owe it to the people) and the infrastructure and services belong to the people for whom they are built and meant. This is why Japan can survive with a high level of debts and a high standard of living. We do not want to copy their policy, but we can learn that the system of local governmental funding at least grants stability and a strong currency.

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2. ECB funding of the EFSF for guarantying liquidity still allows incentives and penalties to enforce budget discipline

We understood in 2008 that bank credits must be safe (that does not mean bank equity). The world economy was at the brink of a dangerous panic that was solved by granting bank lenders and deposits the necessary safety. All these measures did hardly cost money to the tax payer, but reestablished trust in the financial system and recovery of the real economy.

We should now learn from this positive experience that reestablishing (market) trust into the governments is now needed and this ALSO requires the central bank. The ECB/EFSF should always be allowed to buy bonds when they drop so deep that markets stop to provide roll over financing. You may have losses as a foreign investor, but nobody can fear that the European currency system may collapse. The markets are waiting for the signal that government credits are at least tradeable so that financial markets continue to work normally.

THE MARKETS LOGICALLY NEED TO HEAR THAT THE EFSF (backed by the ECB) MAY BUY ALL GOVERNMENT BONDS AT MARKET PRICE IF THEY HAVE DROPPED TO THE EXTENT THAT FRESH PRIVATE SECTOR FINANCING DRIES OUT.

A minimum number for intervention should be fixed from time to time, but this should be the job and the competence of the president of the ECB in coordination with ESFS and it could change according to the situation and be e.g. 50 % of par. It should not offer free lunches to speculation, but just keep the markets working.

The EFSF can then negotiate and refinance those governments allowing them to issue new papers in exchange to maturing bonds (below nominal but much higher than market price at which the EFSF has intervened by buying the bonds) that will allow a profit to the EFSF and enable floating interest rates depending on the borrowers deficit. The lower the deficit the lower should be the interest rate and vice versa.

This means the community helps, but it will get paid with a profit like a distressed lender in case borrowers don't improve. The papers will then immediately be bought by the regional citizens because they have benefit from the regional state guaranty.

This mechanism will also incentivize governments to get new money from the private sector (distressed investors) instead of only turning to Brussels for help from the EFSF and thereby eventually get more attractive deals than those offered from the EFSF. As soon as new long-term interest rates and maturities are defined for the restructuring countries, also foreign investors (bond funds) will absorb the restructured papers assuming the risks of fluctuating quotations like with shares and the EFSF will be able to repay the ECB.

By this way liquidity and incentives for budget discipline are solved at the same time. The dilemma is solved.

The liquidity securing funds from the ECB will only be temporarily needed until i.e. Greek debts restructuring is completed. Ireland and Portugal will try to avoid this costly procedure that gives losses to the creditors and profits and foreign influence to the EFSF and deal with their internal citizens.

Summary

Creditor participation only for foreigners and the EFSF can buy bonds of Euro governments without limit but only at market price whereby the intervention can be at a low price, decided by the EFSF and the ECB based on deficit levels and market dynamics.

Liquidity can be assured, financial markets will refocus on the real economy and have no more reason to freeze in paralysation like some bond markets.

Europe can give itself the same global regulation power and financial global influence to defend its economic interests as a strong and reliable partner like the US and China.

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