

ESM = Hedge Fund. ECB = Its Prime Broker. Will the ESM be UCITS?

The world's major central banks need to buy the debt issued by their governments. This is not just to boost the economy by increasing money supply. It is mostly because no one else will buy their junk bonds.

Most countries are able to do this, except the Eurozone. In the Eurozone, there are a number of countries who need to have their junk bonds bought by their central bank and there are also a few countries who don't. These countries, understandably, don't want the central bank to go about buying any junk bonds, even, or especially those issued by their fellow members. The ECB is not allowed to buy government bonds. So in December last year, the ECB came up with a clever plan. It lent money to private commercial banks in such a way that they had no choice but to buy the junk bonds issued by their respective national treasuries. This was the LTRO. The countries that are not so broke and don't issue junk were not too happy about this. In the meantime, the countries that are broke have, under austerity measures, seen their economies get a bit worse, which is no good for tax revenues, and no good for debt service, and therefore no good for their creditors. So they need to refinance themselves and roll over their junk bonds. Once again, no one will buy this PIKable junk. So they look to their central bank to buy them. But the ECB cannot.

So here is the cunning plan. The ESM is established with a banking licence so it can borrow from the ECB. The ESM is

basically the proposed successor to the EFSF and the EFSM. Don't ask me what those are, I'm not sure I know. The ESM will basically be a hedge fund domiciled in Luxembourg, (one wonders if they will make it a UCITS and offer it to retail investors,) whose equity capital will be funded by the Eurozone member states, including (and one wonders quite how this works) the broke member states, and which will additionally be levered by the ECB. Technically, the ESM is a hedge fund and the ECB its prime broker.

It will be interesting to see if the Germans will invest in this hedge fund. They are being asked to seed it and be the largest investor with 27% of the equity capital. Not only that, Germany is a significant owner (19%) of the prime broker as well.

It is hard enough to get the Germans to invest in a for profit hedge fund but one has the feeling the ESM will be a not-for-profit hedge fund, the only one of its kind.

And what of the prime broker agreements? What leverage is being offered? At what cost? What are the margin requirements? Its going to be a long night.