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Policy Brief

# Making the European Stability Mechanism Work

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# Making the European Stability Mechanism Work

## By Alessandro Leipold


Alessandro Leipold is chief economist of the Lisbon Council. He joined the Lisbon Council in 2010 after a distinguished career in economics, international finance, banking, the European institutions and the International Monetary Fund (IMF), where he served as acting director of the IMF's European Department until 2008.

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**'The European Stability Mechanism (ESM) represents the most ambitious regional financing arrangement ever undertaken in terms of size and coverage.'**

After repeated procrastination, a period which turned "kicking-the-can-down-the-road" into a hackneyed phrase, Europe is now dashing to implement two major institutional initiatives. The twin pillars on which the European Union has staked the success of its battle to overcome the euro-debt crisis are 1) a new "fiscal compact," centred on greater fiscal discipline, more automatic sanctions, and stronger surveillance, adopted by 25 of the 27 EU member states, and 2) a permanent crisis management institution, the European Stability Mechanism (ESM), for euro area members. Faced with the risk of disintegration of the monetary union itself, both these proposals have been placed on a fast track, with the intergovernmental fiscal compact treaty to be signed in early March 2012, and a (revised) ESM Treaty signed on 02 February 2012.[1] The ESM Treaty is to come into force once it is ratified by countries representing 90% of the mechanism's subscribed capital, with the aim of having the arrangement in place by July 2012, one year ahead of the original schedule.

The European Stability Mechanism represents the most ambitious regional financing arrangement ever undertaken, in terms of size and coverage. It is thus important to consider the evidence about what regional financing arrangements can and cannot do and, on this basis, determine how the ESM might be structured to maximize its effectiveness and impact. Scholars describe the rationale for regional risk pooling as a form of "self-insurance," an arrangement in which the parties at risk seek insurance coverage through mutual support, without recourse to external sources of funding.[2] But the recent history of the European debt crisis – and the so far unsuccessful effort to restore stability and confidence to the euro area – is in itself a useful illustration of the limits of self-insurance in regions subject to highly correlated risks. If the stability mechanism proves simultaneously too little to be effective and too large to sit easily on the political economy basis of the countries that formed it, it may ultimately become subject to the very contagion it was set up to prevent. The original design and scope of the mechanism itself are consequently vital to the ultimate success of the exercise.

The evident limits on "self-insurance" bear an important lesson: Europe cannot solve its problems on its own. In this light, the creation of a full-fledged European institution that would simply mimic the International Monetary Fund (IMF) would not be the best, most sensible way to help Europe exit the crisis. More efficient and helpful would be a mechanism that provides an additional line of defence, complementing IMF and EU resources. The guiding principles should be those of additionality to and consistency with the global financial architecture.

1. *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union,* DOC/12/2, 01 February 2012, and *Treaty Establishing the European Stability Mechanism,* DOC/12/3, 01 February 2012.
2. See, *inter alia,* Julie McKay, Ulrich Volz and Regine Wölfinger, "Regional Financing Arrangements and the Stability of the International Monetary System," *German Development Institute (DIE) Discussion Paper 13/2010* (Bonn: DIE, 2010), and Barry Eichengreen, "Insurance Underwriter or Financial Development Fund: What Role for Reserve Pooling in Latin America?," *NBER Working Paper 12451* (Cambridge: National Bureau of Economic Research, 2006).

> 'In a global world, a systemic crisis – such as that of the euro area – requires a global approach, in terms of timeliness, perspective, expertise and resources.'

This policy brief will set out a number of key requirements for a successful European stability mechanism. Specifically, we will argue that the ESM should have: 1) a single crisis manager (versus the "too many cooks" arrangement in the current set-up); 2) a critical mass of readily available resources ("show me the money," as Jerry Maguire would say); 3) clarity and predictability of interventions (which is vital to countries that may need them, as well as to reassure markets and investors that interventions are not subject to political meddling and outcome-defeating compromises); and 4) an efficient governance structure (so that decision-making remains speedy and rational). Finally, we will argue that a common priority – deserving of Europe's active support – is the creation of a robust global safety net, advancing work on a *global* stability mechanism, while also reviving consideration of a formal international debt restructuring mechanism. Put simply, in a global world, a systemic crisis – such as that of the euro area – requires a global approach,

### The European Stability Mechanism: A Seven-Step Programme

- **Recognise that Linkages Fuel the Fire:** Given highly correlated risks, the euro area does not constitute an optimal set of countries for risk sharing. Once a crisis is systemic, self-rescue may be beyond reach even for a wealthy region.
- **Supplement, Do Not Supplant:** A self-standing European financial arrangement cannot suffice in itself. However, the ESM can usefully provide an additional line of defence, supplementing IMF resources.
- **Rely on a Single Crisis Manager:** Effective crisis management requires a single coordinator. The troika's three "cooks" are two too many. The best suited organisation for centralised crisis management on a range of criteria is the IMF.
- **Show Us the Money:** Europe must be seen to make an adequate financial effort in a form that can be readily mobilised. The present cap on the ESM's lending volume must be raised, and the phased injection of paid-in capital accelerated.
- **Ensure Certainty About the ESM's Interventions:** Present legal ambiguities risk generating uncertainty. Precautionary instruments must clearly be part of the ESM's readily deployable arsenal, beyond legal challenge. However there is no need to "re-invent the wheel" with new and untested facilities: keep it simple.
- **Reduce the Muddle of Intergovernmental Decision-Making:** Proceed with extensive delegation from the ministerial (highly political) board of governors to the more technical board of directors.
- **Strengthen the Global Financial Architecture:** A priority, which Europe should actively support, is to advance work on a robust global financial safety net, and to revive consideration of a sovereign debt restructuring mechanism. Europe holds the sway in the IMF to advance these objectives.

‘Pronounced inter-linkages among euro area economies and financial systems facilitate cross-country spillovers and heighten contagion risks.’

in terms of timeliness, perspective, expertise, and resources, able to reassure markets that firewalls are secure and impregnable. Under these circumstances, the truly European response should be not simply to catapult European institutions to the forefront of the crisis-fighting effort, but to help build up new and more effective global arrangements where the crisis-fighting response can be more robust. For a summary of the recommendations, see the box “The European Stability Mechanism: A Seven-Step Programme” on page 3.

## Linkages Fuel the Fire: The Limits to Regional Self-Insurance

Outside of Europe, regional financing arrangements – notably the Chiang-Mai Initiative in Asia and the Latin American Reserve Fund – were set up largely as a political response to dissatisfaction with the IMF’s handling of those regions’ crises and with their under-representation in the IMF’s governing bodies.[3] These two factors are not at play in Europe, where the political driver for a regional financing arrangement lies rather in the concept of mutual assistance embodied in Article 143 of the Lisbon Treaty.[4]

Apart from these political motivations, the economic rationale for regional financial arrangements is that of risk sharing via a pooling of resources. Whether this rationale applies to the EU, or indeed to any country grouping, is fundamentally a question of risk assessment – and, once the risk is assessed, how to effectively insure against it. A basic tenet of the insurance industry is that an “insurance mechanism works most effectively when dealing with risks that are not correlated with one another,” that is where “the likelihood of a claim occurring is not impacted by the fact that another claim has occurred.”[5] In international economics, too, a rich literature provides empirical evidence of what is in fact intuitive: that the gains from risk sharing diminish the higher the correlation of risks among participants.[6]

This conclusion applies especially to the euro area, where pronounced inter-linkages among euro area economies and financial systems facilitate cross-country spillovers and heighten contagion risks. Indeed, the existence of highly correlated shocks was one of the reasons for the creation of the European Monetary System (EMS) in 1979 and of European Monetary Union (EMU) itself as from 1999. In short, “linkages fuel the fire” and eurozone countries are susceptible to systemic crises, defined by the IMF as “episodes of widespread financial

3. See Tadahiro Asami, “Chiang Mai Initiative as the Foundation of Financial Stability in East Asia,” *Association of Southeast Asian Nations Publication* (Jakarta: ASEAN, 2005), and José Antonio Ocampo (ed.), *Regional Financial Cooperation* (Washington DC: Brookings and ECLAC, 2006). For a general overview, see Domenico Lombardi, *Financial Regionalism: A Review of the Issues* (Washington DC: Brookings, 2010).
4. Consolidated version of the *Treaty on European Union and the Treaty on the Functioning of the European Union and the Charter of Fundamental Rights of the European Union,* Doc. 6655/2/08, REV 2.
5. Wayne Fisher, *Risk in Non-Life Insurance Underwriting* (New York: Enterprise Risk Management Institute International, 2010).
6. For example, Jean Imbs and Paolo Mauro illustrate how currency areas and countries with high trade linkages do not constitute “optimal pools of countries from a risk sharing point of view” in Imbs and Mauro, “Pooling Risk Among Countries,” *IMF Working Paper WP/07/132* (Washington DC: IMF, 2007). Similarly, José Luis Machinea and Daniel Titelman observe that “the ability of a reserve pool to cushion the impact of external shocks depends on the ‘insureds’ not all being affected by these simultaneously” in Machinea and Titelman, “Less Volatile Growth? The Role of Regional Financial Institutions,” *CEPAL Review* 91, 2007.

> ‘Once a crisis becomes systemic, spreading to a major part of a region, it is difficult for the region to salvage itself, as any assistance given is seen to weaken the provider and dent his creditworthiness.’

stress where several economies are affected at once through their direct or indirect linkages to other economies under stress.”[7] The ESM Treaty itself explicitly recognises as much, noting: “Given the strong interrelation within the euro area, severe risks to the financial stability of member states whose currency is the euro may put at risk the financial stability of the euro area as a whole.”[8]

Once a crisis becomes systemic, spreading to a major part of a region, it is thus difficult for the region to salvage itself, as any assistance given is seen to weaken the provider and dent its creditworthiness. Questions consequently arise about the credit quality of a structure in which everyone is guaranteeing everyone else, such as the current European Financial Stability Facility (EFSF). Such difficulties of self-insurance for the eurozone became apparent in the course of 2011, as steps to bolster the EFSF faltered, and came to a head with Standard & Poor’s downgrades of some of the facility’s AAA guarantors and, ultimately – in a cascading domino effect – of the EFSF itself in January 2012. As a result, the spread of EFSF bond yields over equivalent German bunds has been well in excess of 100 basis points since October 2011 – more than double the level prevailing in the summer of 2011, and generally slightly above that of France (see Chart 1 below for a look at the widening yield spread of EFSF and French bonds over German bunds since June 2011).

Chart 1: EFSF Bond Spread


Source: Thomson Reuters Datastream

7. IMF, *The Fund’s Mandate – The Future Financing Role: Reform Proposals* (Washington DC: IMF, 2010). For a comprehensive analysis of stress transmission, see *ibid.,World Economic Outlook* (Washington DC: IMF, 2007).
8. ESM Treaty, *op. cit.,* para. (6) of Preamble.

‘A broad lesson from past crises is the importance of a single coordinator or point of reference in crisis management.’

In sum, the euro area does not constitute an optimal set of countries for risk sharing. A self-standing regional financing arrangement cannot therefore suffice in itself, and risks being overwhelmed (and possibly even engulfed) as a crisis spreads.

## ‘Too Many Cooks...’

A broad lesson from past crises that was not apparent at the time but has become evident with the current situation in Europe is the importance of a single coordinator or point of reference in crisis management – a role traditionally fulfilled by the IMF.

A useful approach to assessing the capacity of an institution to provide effective crisis financing and management is found in the work of McKay, Volz and Wölfinger, who identify six key criteria for evaluating the likely success or failure of a crisis-fighting mechanism.[9] These six points are summarised in the following section, along with a brief comparison between the capacities of the IMF and ESM in each area:

**1) The size of the financing pool or resources accessible.** ESM resources are insufficient to solve the European crisis on their own but can helpfully supplement those of the IMF. On this score, each institution needs the other;

**2) Timely access to relevant information.** On this point, there is no appreciable difference between the two institutions, though presence on the ground and the intensity of EU surveillance procedures provide the ESM with an edge. This would argue in favour of the IMF shifting its headquarters in Europe from Paris to Brussels, re-opening the office that was precipitously closed during the budget retrenchment of 2007-08;

**3) High quality analytical expertise.** At the IMF, these capabilities are broader and cover all areas (notably banking and financial markets). The IMF can also draw on a vast repository of accumulated cross-country experience as part of its institutional memory. In contrast, the costs of Europe’s “learning-by-doing” have been evident in many areas of the present crisis – most notably with regard to debt restructuring and the related issue of private sector involvement;[10]

**4) Speed in decision-making.** This is considerably superior at the IMF, which has specific fast-track financing procedures known as the emergency financing mechanism.[11] Via this mechanism, in late 2008, arrangements were approved within three and a half to six weeks of the initial indication of interest by the authorities of half a dozen countries,

9. See Julie McKay, Ulrich Volz and Regine Wölfinger, *op. cit.* The approach is reprised by Barry Eichengreen, *The International Financial Architecture and the Role of Regional Funds* (Berkeley: University of California, 2010).
10. It took Europe months of missteps on private sector involvement before falling back on a commitment to “strictly adhere to the well-established IMF principles and practices.” After long debate, the IMF ultimately left the issue to the constructive ambiguity of a case-by-case approach as the best means to handle a complex matter. One would in fact be hard put to find “well-established principles” on private sector involvement set out clearly in an official IMF document; the chapter on experience with debt restructurings in the Fund’s official history is tellingly entitled “Case by Case: A Retrospective on the Debt Strategy.” See James M. Boughton, *Silent Revolution: The International Monetary Fund 1979–1989* (Washington DC: IMF, 2001).
11. See IMF Survey, “Amid Crisis, IMF Emphasizes Readiness to Lend Quickly,” *IMF Survey Magazine,* 09 October 2008.

## 'The simplest – and indeed first-best approach – would be to view the ESM as a pool of resources that can be made available to complement the financing of IMF-led programmes.'

including Hungary, Iceland, Latvia, and Ukraine. The process envisaged for the ESM, with the central role assigned to the eurogroup finance ministers in their capacity as the ESM board of governors, is significantly more laborious and time-consuming;

**5) Impartiality in lending decisions.** Again, this is distinctly greater at the IMF, given its global membership, less politicised decision-making, and – in virtue of its preferred creditor status – absence of a direct stake in the game. In contrast, decision-making in Europe has been highly politicised and EU creditor countries are exposed via their guarantees to the EFSF, as is the ECB itself through its holdings of peripheral country debt and of peripheral banks' bonds as collateral. In the ESM this will be attenuated, but not fully overcome, by the Treaty provision that "ESM loans will enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF over the ESM;"[12]

**6) Mechanisms for monitoring and enforcing conditionality.** The ESM, thanks to the frequency of interaction within the EU and the mechanisms foreseen by the fiscal compact treaty, is likely positioned to have greater leverage in this respect. Indeed, the ESM Treaty sets ratification of the fiscal compact as a precondition for benefitting from ESM assistance as of 01 March 2013.[13]

On balance, these elements would point to the comparative advantages of the IMF as a crisis manager and to the consequent benefits of centralising crisis management at the Fund.[14] This contrasts with the "troika" arrangement and, *a fortiori*, with the 17 countries in the eurogroup and the 27 in the EU. The simplest – and indeed first-best approach – would be to view the ESM as a pool of resources that can be made available to complement the financing of IMF-led programmes. In such a set-up, the EU institutions would of course remain in charge of all eminently political decisions affecting the European Union and EMU proper – for example, the degree of fiscal union, internal surveillance and crisis prevention procedures, common policies, etc. – with the Fund for its part being the principal crisis manager.

Nonetheless, whatever the merits of the case, it is unlikely that EU leaders will be prepared to act as mere financiers of the IMF, leaving the details of programme design and crisis management to what is viewed as a Washington-centric institution. In fact, the modified ESM Treaty of early February even takes a few steps backward from the language contained in the earlier version, signed in July 2011, incorporating several restrictive provisos to IMF involvement. Specifically, it drops the phrase "in all circumstances" from the sentence that originally read "in all circumstances, the active participation of

12. ESM Treaty, *op. cit.,* para. (13) of Preamble.
13. ESM Treaty, *op. cit.,* para. (5) of Preamble.
14. Many authoritative voices have, in recent months, called for the restoration of a strong and independent presence at the centre of the international financial system, via a reassertion of the IMF's global stewardship. See, for example, Mohamed El-Erian, "It's Time for the IMF to Stand Up to the European Bullies" *Financial Times,* 29 December 2011; William Rhodes, "IMF Must Rekindle Its Old Strengths and Glory" *Financial Times,* 14 November 2011; and Lawrence Summers, "IMF Must Play its Part in Any Euro Solution" *Financial Times,* 09 December 2011.

'Europe cannot aspire to have at hand sufficient capacity to provide simultaneous support to multiple member states. But it must be seen to be doing the most it reasonably can.'

the IMF will be sought." In a similar vein, it adds the qualifier "wherever possible" to the expectation that a euro area member state requesting financial assistance from the ESM would address a similar request to the IMF. And the participation of the IMF in assessing debt sustainability shifts from being envisaged "whenever possible" to "whenever possible *and* [emphasis added] appropriate."[15]

While the lingering institutional diffidence, evident in the hedging of these formulations, is misplaced, it cannot be ignored. In the rest of this policy brief, we will attempt to take a middle road, guided also by the *G20 Principles for Cooperation between the IMF and Regional Financing Arrangements* (endorsed by G20 finance ministers and central bank governors in october 2011), and focus on the main elements that could contribute to a successful ESM, with respect to its firepower, instruments, and governance structure.

## The Size and Credibility of the Financing Pool – 'Show Me the Money'

Europe cannot realistically assemble sufficient and credible financial firepower on its own to assuage market concerns on the euro debt problem, but it can certainly contribute to that end by meeting two basic requirements:

a) It has to be seen to be making a significant effort in this direction; and
b) It has to provide sufficient resources in a form that can be readily mobilised (no "funny money," as envisaged in some of the EFSF's leverage schemes).[16]

Taking these in turn, the first requirement concerns the size of the ESM's resources. For reasons detailed above, Europe cannot aspire to have at hand sufficient capacity to provide simultaneous support to multiple member states, possibly including some of the largest. But it must be seen to be doing the most it reasonably can. At present, the maximum lending volume of the ESM is capped at €500 billion, including the outstanding EFSF loans, as the latter institution is set to run in parallel with the ESM for one year.[17] However, it has been agreed to reassess the adequacy of this lending ceiling at the European Council in early March 2012, before entry into force of the ESM Treaty.[18] At a minimum, the Council should agree to allow the remaining unused resources of the existing EFSF to be added to those of

15. ESM Treaty, *op. cit.,* para. (8) of Preamble, and Article 13.1 (b).
16. Following a marathon of meetings in October 2011 and faced with mounting concerns about the insufficiency of the EFSF's resources as the crisis spread, euro area heads of state and government announced the intention to maximize the EFSF's capacity with two approaches. These are complex, as they attempt to resolve the conundrum of raising resources without increasing euro area countries' guarantee commitments – which most members were either unwilling or unable (given credit rating concerns) to do. This was to be achieved essentially via leverage – under some calculations, by four to five times. The first option was to provide credit enhancements to primary sovereign bond issues. The second option envisaged the creation of one or more "co-investment funds" to "allow the combination of public and private funding to enlarge the resources available," including by tapping emerging market funds. See EFSF, *Maximising the Capacity of the EFSF – Terms and Conditions* (Luxembourg: EFSF, 2011). The proposed financial engineering was met with widespread scepticism; see for example the Financial Times Lex Column, "EFSF: More Pop Gun Than Bazooka," *Financial Times,* 30 November 2011.
17. ESM Treaty, *op. cit.,* Article 39.
18. While this deadline is close, the timing is unfortunate, as it comes after the G20 ministerial meeting of end-February 2012, at which Europe could have helped promote collective action (including by emerging markets) to strengthen global safety nets with evidence of already having done the utmost to help itself.

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the new ESM, at least during the present acute phase of the crisis, re-examining the overall adequacy upon expiration of the EFSF in mid-2013. In the latter regard, clarification is also needed about plans after the end of the EFSF: it would not be a good signal to anticipate a return to a smaller pool of available resources.

The second requirement is that the resources be readily available for rapid deployment, which in turn depends on the ESM's funding method and capital structure. Here, euro area member states have established that the ESM will have a total subscribed capital of €700 billion, of which €80 billion will be in the form of paid-in capital and the balance of €620 billion will be callable capital from euro area members.[19] While the final resulting ratio of 11.4% between paid-in and subscribed capital is higher than that of other similar institutions (at the European Investment Bank, for example, the ratio is 5% and the average for multilateral development banks is around 7%), this proportion will be much lower at the start of the mechanism, as capital is to be injected only gradually, in five equal annual instalments. Paid-in capital in the first year will thus amount to a mere €16 billion, or only 2.5% of total subscribed capital.

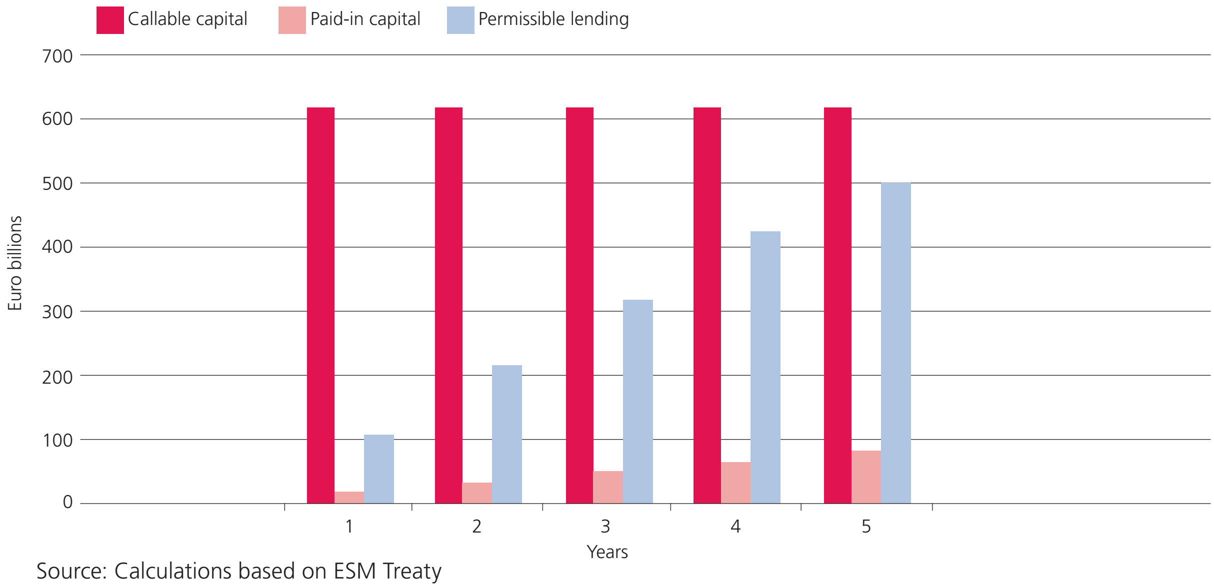
In addition, the ESM Treaty establishes that paid-in capital has to be at least 15% of the ESM's issuances, so that the mechanism's lending capacity would be effectively constrained to no more than €107 billion in its first year of operation (see Chart 2 on page 10 for a look at the ESM's proposed capital structure and lending capacity). To avoid an unduly low proportion of paid-in capital during the early part of the five-year transition period, and the related constraint on ESM lending, euro area members will need to accelerate the payment of their share of paid-in capital. Indeed, such acceleration would appear to be requisite to observe the Treaty's provision whereby, throughout the five-year period of phased capital instalments, ESM members are to provide paid-in shares in an amount sufficient to maintain both the minimum 15% ratio and to "guarantee a minimum combined lending capacity of the ESM and of the EFSF of €500 billion."[20]

A heavy reliance on callable capital raises a separate risk – the unfolding of "a 'can't pay, won't pay' scenario."[21] An undertaking to inject capital, when and if asked, is unproblematic when sovereigns are in good financial health, but becomes a challenge if the request comes – as is likely – at a time of mounting financial stress. A scenario in which member countries are severely constrained in their ability to respond to a capital call is thus quite likely, given also the increasing recourse to callable capital subscriptions by several other institutions (notably multilateral development banks).[22] One cannot but wonder about the realism of the ESM Treaty's provision (Article 8.5) whereby the obligation of an ESM member to contribute to the authorised capital stock

19. ESM Treaty, *op. cit.,* Article 8.
20. ESM Treaty, *op. cit.,* Article 41.
21. See Wolfgang Münchau, "A Grand Bargain that Cannot End the Crisis" *Financial Times, 27 March 2011.*
22. For example, Italian and Belgian capital commitments to multilateral development banks already amount to 3% of their gross domestic product; see Fitch Ratings, *MDBs Increasingly Relying on 'Callable Capital' to Fund Fast Growth in Lending* (London: Fitch, 2011).

‘The definition of the ESM’s instruments, the pre-conditions for their use, and their degree of conditionality is a somewhat confusing attempt to reconcile different decisions taken over time on these issues.’

Chart 2: Capital Structure and Lending Capacity of the European Stability Mechanism




Source: Calculations based on ESM Treaty

would continue to stand even if such a member were receiving financial assistance from the ESM.

Simply put, euro area members should inject ESM capital as rapidly as feasible, where possible with at least two instalments (amounting to 40% of the amounts due) already in 2012. What is feasible will differ among countries, with some in a better position to accelerate payments than others. The guiding principle should be “can pay, will pay.” Unfortunately, initial indications that Germany stood ready to take the lead have given way to a wait-and-see attitude, and a classic “first-mover” problem has emerged, with resulting collective paralysis.

## The Range of ESM Interventions – Make it Clear, Simple and Predictable

The definition of the ESM’s instruments, the pre-conditions for their use, and their degree of conditionality – as ultimately set out in the Treaty of February 2012 – is a somewhat confusing attempt to reconcile different decisions taken over time on these issues, in a simple manifestation of “time inconsistency.”[23] In practice, as the euro crisis worsened, EU leaders shifted from an initial position that circumscribed the ESM’s mandate quite narrowly to one that extended its range of interventions to include not only direct financial assistance but also precautionary lending, financing of bank recapitalisations, and interventions on both primary and secondary debt markets.

23. While time inconsistency dynamics in economics is a sophisticated construct, in its simplest form it can be understood as describing a situation where a decision-maker’s preferences change over time in such a way that what is preferred at one point in time is inconsistent with what is preferred at a later point in time.

**'As the euro crisis worsened, EU leaders shifted from an initial position that circumscribed the ESM's mandate quite narrowly to one that extended its range of interventions.'**

The first basic legal text for the ESM was approved in late March 2011. To avoid the political complications of a new Treaty and related referenda, it was agreed then that the ESM could be set up by adding a paragraph to Article 136 of the Treaty on the Functioning of the European Union (TFEU), via the so-called simplified revision procedure. The wording of this paragraph reads:

*"The member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."*[24]

As is apparent, this language – that has not been modified, given the related political complications – sets a high bar for the activation of the ESM (only if "indispensable" to safeguard overall euro area stability) and is tough on the required conditionality (with "any required financial assistance... subject to strict conditionality.")[25] Indeed, a strict interpretation of this text would seem to rule out precautionary lending, amongst other things. Despite the widespread emphasis in the present debate on the need for strong firewalls to contain the spread of contagion to countries such as Italy and Spain, the language can be read as barring pre-emptive action by the ESM to ring-fence a member that still has access to private financing and does not as such present a risk to "the stability of the euro area as a whole," nor requires the imposition of "strict" conditionality.

Subsequent to the adoption of this text, in July 2011, the eurogroup heads of state and government decided to significantly expand the range of activities of the EFSF and, by extension, those of the future ESM to include not only precautionary lending, but also the financing of bank recapitalisations and interventions on primary and secondary debt markets.[26]

The reconciliation of these expanded activities with the narrow scope of the ESM's initial mandate has entailed some creative but ambiguous drafting in the final version of the ESM Treaty. In particular, on conditionality, the final version of the Treaty attempts to marry the current EFSF's reference to "appropriate" conditionality with the ESM's "strict" criterion, leading to woolly language as follows: "the ESM may provide stability support to an ESM member subject to strict conditionality, appropriate to the financial assistance instrument chosen. Such conditionality may range from a macro-economic adjustment programme to continuous respect of pre-established eligibility conditions."[27] But the concept of pre-established eligibility, which is fully reasonable, is generally understood to apply to strong performers, caught up as "innocent by-standers," and thus deserving of low, if any, conditionality – it sits awkwardly with the general call for strict conditionality.

24. European Council, decision of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for member states whose currency is the euro (Decision 2011/199/EU).
25. Such confining language harks back to an attitude prevailing in the EU's initial handling of the crisis. Inspired in particular by the ECB, the preoccupation was that, to avoid moral hazard, assistance should be made available only as a very last resort *(ultima ratio),* with tough conditions, and at unattractive interest rates. For a critique of this approach, see Alessandro Leipold, *Thinking the Unthinkable: Lessons of Past Sovereign Debt Restructurings* (Brussels: Lisbon Council, 2011).
26. See *Statement by the Heads of State or Government of the Euro Area and EU Institutions,* 21 July 2011.
27. ESM Treaty, *op. cit.,* Article 12.1.

‘Some key crisis prevention or management tools do not appear to be readily available in the ESM’s arsenal – or, in any event, their deployment risks being subject to lengthy negotiations.’

In this setting, there is a risk that the tension between the general provision allowing the creation of the ESM and the specifics laid out subsequently in the ESM Treaty, based on a wider mandate, could induce some member states, or at least their constitutional courts, to invoke a strict interpretation of the TFEU’s Article 136 and hinder any intervention beyond direct stability support. Furthermore the ESM Treaty envisages that all forms of assistance – including bank recapitalisations and debt market interventions – be subject to conditionality “detailed in a memorandum of understanding” to be negotiated with the ESM member concerned[28] – an inevitably time-consuming process not suited to the urgency and preventive nature of these interventions. Consequently, some key crisis prevention or management tools do not appear to be readily available in the ESM’s arsenal – or, in any event, their deployment risks being subject to lengthy negotiations and/or complex legal exegesis, with the associated delays impairing their effectiveness.

In particular, for the ESM to be effective, it will have to be able to intervene rapidly on a precautionary basis. To this end, however, the advisable course of action is *not* that of devising new and potentially complicated instruments. There is no need for Europe to attempt to replicate the IMF’s extensive arsenal on a regional scale – not only would it be futile to do so in the few months left before the ESM Treaty’s entry into force, but it would be an inefficient duplication of efforts.

A proliferation of facilities also risks undermining the “consistency of lending conditions,” recommended in the G20 Principles, seen as needed “to prevent arbitrage and facility shopping, in particular as concerns policy conditions and facility pricing.”[29]

Furthermore, the appropriate design of precautionary or crisis-prevention instruments has consumed the international community for many years, and only recently has the IMF seemingly found an effective formula (with in particular its so-called flexible credit line, used successfully by Mexico, Colombia, and Poland; see Chart 3 on page 13 for an illustration of how the approval of flexible credit lines led to improved market confidence.)[30] More recently, the IMF also introduced a precautionary and liquidity line designed to meet flexibly the liquidity needs of countries with sound economic fundamentals but with some remaining vulnerabilities.[31] In motivating the facility, the staff report explicitly referred to “possible global repercussions from the on-going turmoil in the euro area.”[32]

The modalities of these Fund facilities are known and understood by market participants. Markets need this sort of certainty and predictability. It will not be helped by the introduction of unknown and as yet unspecified facilities, such as those passingly mentioned in the ESM Treaty (Article 14.1) – i.e., an ESM “precautionary conditioned credit line” and an “enhanced conditions credit line.”[33]

28. ESM Treaty, *op. cit.,* Articles 14.2, 15.2, 16.2, 17.2 and 18.3.
29. See *G20 Principles for Cooperation between the IMF and Regional Financing Arrangements,* endorsed by G20 finance ministers and central bank governors in Paris, 15 October 2011.
30. See IMF, *Factsheet – The IMF’s Flexible Credit Line* (Washington DC: IMF, 2011).
31. See IMF, *Factsheet – The IMF’s Precautionary and Liquidity Line* (Washington DC: IMF, 2011).
32. See IMF, *The Fund’s Financing Role: Reform Proposals on Liquidity and Emergency Assistance* (Washington DC: IMF, 2011).
33. For its part, the EFSF, in its relevant guideline on precautionary programmes has already introduced (at least on paper) three types of precautionary credit lines, unknown to the markets: a “precautionary conditioned credit line” (PCCL); an “enhanced conditions credit line” (ECCL); and an “enhanced conditions credit line with sovereign partial risk protection” (ECCL+). See EFSF, *EFSF Guideline on Precautionary Programmes* (Luxembourg: EFSF, 2011).

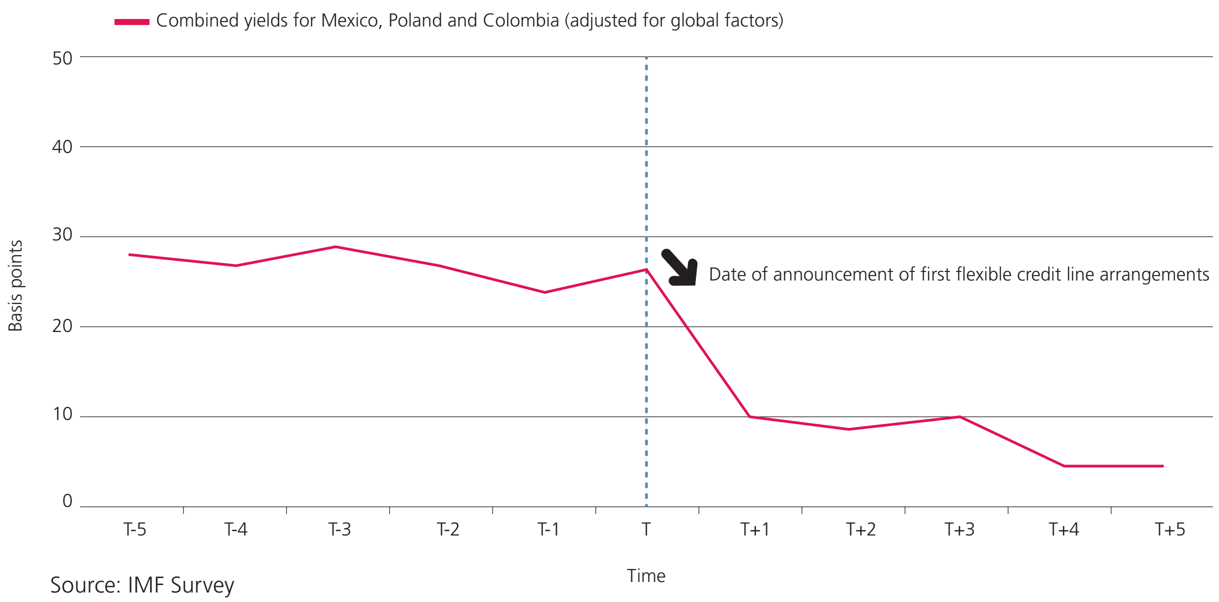
‘To the extent that the euro area crisis is largely a crisis of governance, the provisions for the ESM’s own governance structure are key.’

The ESM’s board of directors, which has been mandated under the Treaty (Article 14.4) to “adopt the detailed guidelines on the modalities for implementing the ESM precautionary financial assistance,” would be well advised to keep it simple. The best way forward would be to provide for ESM co-financing under the IMF’s existing early intervention mechanisms, giving market participants the certainty, predictability and related confidence of a known framework.

## Governance – The Intergovernmental Muddle

To the extent that the euro area crisis is largely a crisis of governance, the provisions for the ESM’s own governance structure are key. However, as currently envisaged, these provisions stand to perpetuate the difficulties seen to date, insofar as the approach remains a narrowly intergovernmental one, the occasion not having been seized to create a community institution fully integrated in the European Union framework. It is of course futile at this point to lament this outcome, though one cannot but share the sentiments expressed by the European Parliament and the ECB.[34] The ECB’s official opinion on the ESM puts it clearly: noting that the ESM is being created as “an intergovernmental mechanism instead of a Union mechanism,” it stresses that “the ECB supports recourse to the Union method and would welcome that, with the benefit

Chart 3: Yields Fall After the Announcement of Flexible Credit Line Arrangements




Source: IMF Survey

34. European Parliament, *Report on the Draft European Council Decision Amending Article 136 of the Treaty on the Functioning of the European Union* (Strasbourg: European Parliament, 2011); and European Central Bank, *Opinion of the European Central Bank on a Draft European Council Decision Amending Article 136 of the Treaty on the Functioning of the European Union* (Frankfurt: ECB, 2011).

'The ESM's governance structure appears doomed to continue to yield slow decision-making, poor communications, and a dominance of national preoccupations, marked by reciprocal vetoes, over common, supranational interests.'

of the experience gained, the ESM would become a Union mechanism at an appropriate point in time."[35]

In the meantime, though, the route is purely intergovernmental, with crisis management by the ESM vested in its board of governors – composed of the eurogroup ministers of finance – with relatively minor tasks delegated to a more technical board of directors.[36] That this is not an effective way to manage a crisis has been amply demonstrated since early 2010, and the ESM's governance structure appears doomed to continue to yield slow decision-making, poor communications, and a dominance of national preoccupations, marked by reciprocal vetoes, over common, supranational interests.

In awareness of these problems, the ESM Treaty attempts to avoid the requirement of full unanimity for all major decisions. It accordingly establishes that decisions on, among others, three key issues (the granting of financial assistance, the lending capacity of the ESM, and changes to its menu of instruments) will be taken by so-called "mutual agreement" – defined as a decision taken unanimously by those countries participating in the vote, with abstentions not preventing the decision from being adopted. While the intent, as noted by the ECB, is to "contribute to the decision-making efficiency of the ESM,"[37] such a procedure of course also means that any one country has a *de facto* veto.

To address this, and ensure that the ESM is in a position to take the necessary decisions in all circumstances, the ESM Treaty (Article 4.4) establishes an "emergency procedure," which would allow decisions by a qualified majority of 85% of the votes cast.[38] The procedure can be invoked in cases "where the Commission and the ECB both conclude that a failure to urgently adopt a decision to grant or implement financial assistance... would threaten the economic and financial sustainability of the euro area." Despite this fairly restrictive language (with its reference to a threat to "sustainability," rather than only "stability"), the provision met with resistance – eventually overcome via the creation of an emergency reserve fund – from Finland, a portent of possible future operational snags.[39]

Such difficulties are inherent to an intergovernmental process and not easily overcome, so that the ESM decision-making process is likely to remain overly politicised and cumbersome. Two steps would nonetheless be helpful: first, proceeding with extensive delegation to the more technical

35. European Central Bank, *op. cit.,* para. 8.
36. Governance vested directly in the hands of politicians differs in important respects with that chosen for the IMF, where its executive directors are commonly characterized as having a "dual" responsibility, owing their duty both to the Fund and to their constituencies, although no explicit reference to such duality is made in the Fund's articles of agreement. Furthermore, the ESM Treaty does not establish, as do the Fund's articles of agreement, that in the discharge of their functions, the managing director and the staff "shall owe their duty entirely to the Fund and to no other authority. Each member of the Fund shall respect the international character of this duty and shall refrain from all attempts to influence any of the staff in the discharge of these functions." An analogous provision would have been well placed for the ESM.
37. European Central Bank, "The European Stability Mechanism," *ECB Monthly Bulletin* (Frankfurt: ECB, 2011).
38. Votes in the ESM will be weighted in proportion to the countries' shares in the institution's capital, as shown in the table on page 15.
39. Arild Moen, "EU Summit Presents Finns with a Conundrum" *The Wall Street Journal,* 16 December 2011.

> ‘Europe is well placed to play a leading role at the IMF in developing a Global Stabilisation Mechanism (GSM) and reviving work on a sovereign debt restructuring mechanism.’

board of directors; and second, as proposed above, leaving day-to-day crisis management essentially to the IMF. Concerns in the latter regard should be assuaged by the considerable sway held by Europe at the IMF: euro area countries garner more than 22% of total IMF voting power, and the EU-27 exceed 30% (by way of comparison, the United States accounts for under 17% of IMF votes). Europe can thus be an influential force for change at the IMF, as taken up in the next, concluding section.

## Take the Lead in Building a Global Firewall

Europe is well placed to play a leading role at the IMF in developing a Global Stabilisation Mechanism (GSM) and reviving work on a sovereign debt restructuring mechanism (SDRM) – with the need for both having been highlighted by the euro area crisis. Such a contribution would aptly complement Europe’s December 2011 commitment to supplement IMF resources by up to €200 billion – which should be followed upon promptly (the self-imposed 10-day deadline having long lapsed). Europe could thus usefully fill the void in international financial cooperation caused by the current bout of inward-looking electoral partisanship in the US, destined to persist through at least 2012.

Work on a global stabilisation mechanism has been requested by the Fund’s shareholders, and – building on other recent initiatives noted above – the IMF’s work programme envisages a discussion, in late March 2012, on the role of global financial safety nets in dealing with systemic crises, taking a broader look at the incidence of systemic crises, the range of international, regional and national responses, any residual gaps in the global financial safety net, and possible options for filling them.[40] Europe should have much to contribute, provided it breaks free from a largely parochial approach to date.[41]

### ESM Capital Contributions Key and Voting Weights

| Country | Voting Weights (in percent) |
|---|---|
| Germany | 27.1464 |
| France | 20.3859 |
| Italy | 17.9137 |
| Spain | 11.9037 |
| Netherlands | 5.7170 |
| Belgium | 3.4771 |
| Greece | 2.8167 |
| Austria | 2.7834 |
| Portugal | 2.5092 |
| Finland | 1.7974 |
| Ireland | 1.5922 |
| Slovak Republic | 0.8240 |
| Slovenia | 0.4276 |
| Luxembourg | 0.2504 |
| Cyprus | 0.1962 |
| Estonia | 0.1860 |
| Malta | 0.0731 |
| Total | 100.0000 |

Source: ESM Treaty

40. IMF, *Statement by the Managing Director on the Work Programme of the Executive Board* (Washington DC: IMF, November 2011).
41. Indicative of the prevailing eurocentrism is the fact that no EU institution or country has considered drawing from the experiences of the Asian or Latin American crises, to possibly deduce some lessons, and there would be several, as outlined for example in Leipold (2011), *op. cit.*.

‘Avoidance of future crises will require the quantum leap toward greater union that is the essential underpinning of a common currency.’

As argued above, a European stability mechanism can be helpful and succeed only as part of a broader system of multilateral co-insurance represented by a full-fledged GSM. It is this project that needs to be put on a fast track, as financial stability is a global public good and, in the words of Christine Lagarde, managing director of the IMF, “a global world needs global firewalls.”[42]

As to the SDRM, the Greek saga has highlighted the need for a permanent international statutory mechanism to handle unsustainable debts, along the lines of an international bankruptcy mechanism. The possibility of such a formal restructuring mechanism was hotly debated in the late 1990s, but foundered by 2003, revealing itself to be among the most intractable issues in international finance. Europe would do well to bring the matter back on to the international community’s work agenda.

By following up on this policy brief’s main recommendations with respect to shared crisis management, adequate financial resources, simple and readily deployable instruments, and adept governance – while also contributing financially and with constructive proposals to the IMF’s global crisis response capabilities – Europe will be seen as striving to help itself and as an international partner meriting global support as may be needed. Against the background of some easing of market pressures, decisive steps in this direction – along with continued ECB support – should help tame the current crisis. Avoidance of future crises will, for its part, require the quantum leap toward greater union that is the essential underpinning of a common currency.

42. Christine Lagarde, “Global Challenges in 2012,” *Speech to the German Council on Foreign Relations*, 23 January 2012.

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**The Lisbon Council asbl**

IPC – Résidence Palace
155 rue de la Loi
1040 Brussels, Belgium

T +32 2 647 95 75
F +32 2 640 98 28
twitter @lisboncouncil
info@lisboncouncil.net



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