LISBON COUNCIL EUROPE 2020 SUMMIT

"Exiting the Crisis: The Next Steps"

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Although this session is entitled "Exiting the Crisis: The Next Steps," my intervention will more modestly review only *some* of the next steps – in particular those concerning the new permanent crisis management institution, the European Stability Mechanism (or ESM), which is the subject of the Lisbon Council's Policy Brief being formally launched today.

The ESM Treaty was signed on February 2, 2012, with the aim of having the arrangement in place by July 2012, one year ahead of the original schedule. It is the most ambitious regional financing arrangement ever undertaken, in terms of size and coverage, well beyond either the Chiang Mai initiative in Asia or the Latin American Reserve Fund. Yet, there has been surprisingly little attention paid to the details of the ESM Treaty.

A close reading of the Treaty brings out four main points.

The first point is: there are limits to what a regional financial arrangement (RFA) can do, and **there are limits to what Europe alone can do**. These limits derive essentially from the fact that, as the ESM Policy Brief puts it, "linkages fuel the fire." The euro area exhibits highly correlated risks: indeed that is why the EMS and EMU were set up in the first place. But – as is intuitive – insurance works best when dealing with risks that are *not* closely correlated. In a closely-knit area, such as the eurozone, contagion can spread very rapidly. This is particularly the case where everyone is guaranteeing everyone else, as in the EFSF – reminding one, perhaps a little unfairly, of Dickens' definition of credit: "Credit is a system whereby a person who cannot pay gets another person who cannot pay to guarantee that he can pay."

Admittedly, this is not really a fair rendition of the EFSF, but that is the caricature markets tended to see in the course of 2011, leading first to a downgrading of some of the facility's triple-A guarantors and ultimately, in a cascading domino effect, of the EFSF itself in January 2012. Indeed, the recent period has seen a steady weakening of confidence in the EFSF, with spreads over German bunds rising steadily since the summer of 2011 and – albeit narrowing more recently – remaining rather elevated and not appreciably different than for France.

The evidence from these developments is that 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.

This point is not directed so much at the Europeans themselves, but rather to all those who maintain – beginning with the United States – that Europe is wealthy enough to help itself. True in the abstract, but not when a crisis becomes regionally systemic – then, self-rescue is beyond reach, even for a wealthy region. The point is that multilateralism is superior to regionalism, and that a crisis with global dimensions, such as this, requires a global response.

That said, however, Europe's partners are right in arguing that **Europe must show to have done the utmost to help itself in terms of readily available resources.** This is the first of three points in "getting the ESM right" – and we are definitely not there yet.

It is now time for Europe to put real money on the table. Not "funny money" à-la-EFSF leveraging of November 2011 – no miraculous multiplication of loaves and fishes. But, as Jerry Maguire put it in the 1996 movie, "show me the money."

For now, we are *not* being shown it: not even the widely touted €500 billion in total lending volume is actually there. Let us explain briefly why. The ESM Treaty provides for a total subscribed capital of €700 billion, of which €80 billion will be in the form of paid-in capital, with the balance of €620 billion in the form of callable capital, if and as needed. But the paid-in capital will be much lower at the start of the mechanism, as it is to be injected only gradually, in five equal annual installments. Paid-in capital in the first year will thus amount to only €16 billion.

Why is this important? In essence because the ESM Treaty establishes that paid-in capital has to be at least 15% of the mechanism's issuances, so that the ESM's lending capacity is effectively constrained to no more than €107 billion in its first year of operation. The €500 billion being spoken about is actually only reached in year 5, when all the paid-in capital will have been injected.

Perhaps aware of the insufficiency of this effort, euro area leaders declared at their December 2011 summit that they stood ready "to accelerate payments of capital" if needed during the phase-in period. They should do so as soon as possible. Ideally, countries with fiscal space should aim to pay at least two (or more) installments this year. What is feasible will differ among countries, but the guiding principle should be "can pay, will pay."

Let us nonetheless assume that the resources will be there, and move on to our second point on "getting the ESM right:" namely, the **need to ensure that the ESM has predictable and readily deployable instruments.**

What is the problem here? It is that different decisions taken over time have generated legal ambiguities, with related uncertainty. Let me explain. The first basic legal text for the ESM was approved in 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), using what is known as the "simplified revision procedure." The wording of this carefully drafted paragraph reads:

"*The Member States whose currency is the euro may establish a stability mechanism to be activated if <u>indispensable</u> to safeguard the stability of the euro area <u>as a whole</u>. The granting of <u>any</u> required financial assistance under the mechanism will be made subject to <u>strict</u> conditionality*."

As is apparent, this language 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"). Indeed, a strict interpretation of this text would seem to rule out, amongst other things, precautionary lending – the pre-emptive firewall everyone says is needed.

Three months after the adoption of this text, in July 2011, EU leaders shifted from this initial, limiting position and – faced with a continued deterioration of the euro crisis – extended the range of possible EFSF and ESM interventions to also include precautionary lending, as well as the financing of bank recapitalizations, and interventions on both primary and secondary debt markets.

You have here a typical manifestation of "time inconsistency" – 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.

The attempt to reconcile these inconsistencies has entailed some creative, but ambiguous, drafting in the final version of the ESM Treaty. In particular, on conditionality, the Treaty has tortured language of this sort: "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 program to continuous respect of pre-established eligibility conditions." But "strict" and "appropriate" sit oddly together, and 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 requiring low, if any, conditionality.

There is a risk that this legal tension between texts approved at different times could induce some Member States, or at least their Constitutional Courts, to invoke a strict interpretation of Article 136 and hinder any intervention beyond direct stability support. Consequently, some key crisis prevention tools – such as precautionary arrangements – may not be readily available in the ESM's arsenal – or, in any event, their deployment risks being controversial and subject to complex legal debate, with associated delays.

If Europe had looked at international experience it would have realized the importance of precautionary instruments earlier on. And the Policy Brief illustrates one such example: the use by three countries (Mexico, Colombia and Poland) of a new precautionary instrument from the IMF, the so-called Flexible Credit Line (FCL), since 2009. The arrangements' announcement was followed, in all three cases, by a distinct strengthening of confidence, reflected in a marked decline in sovereign yields.

In sum, precautionary instruments should unambiguously be part of the ESM's readily deployable arsenal, and placed beyond legal challenge. That said, there is no need to "re-invent the wheel" with new and untested facilities, and the guiding principle should be: keep it simple, and supplement – but do not supplant – available IMF instruments.

The third and final point on "getting the ESM right" concerns governance, and the need to **improve on the present muddle of inter-governmental decision-making.** The euro area crisis has been largely a crisis of governance, but we are not breaking loose from it. That is, the occasion was not seized to make the ESM a community institution fully integrated in the European Union framework. On the contrary, the ESM's governance structure perpetuates the strictly intergovernmental approach followed to date.

Crisis management will accordingly remain in the hands of the eurogroup ministers of finance – now in their guise as the ESM's Board of Governors – and only relatively minor tasks will be delegated to the more technical Board of Directors. So you have an essentially unchanged governance structure, doomed to continue to yield “more of the same”: a dominance of national preoccupations over common, supranational interests; slow decision-making; and poor communications.

Such difficulties are not easily overcome within an intergovernmental approach. Two steps would nonetheless be helpful: first, proceeding with extensive delegation to the more technical Board of Directors; and second, leaving day-to-day crisis management essentially to one crisis manager, which we argue should be the IMF. While that is undoubtedly controversial, international experience has shown the importance of relying on a single coordinator and manager. The troika’s three “cooks” are already two too many – and in fact there are even more “cooks too many”: think of the 17 countries in the eurogroup and the 27 in the EU. Better working arrangements have to be found.

To conclude: there is no doubt that the latest agreement on Greece has bought Europe some time, providing a breathing space. And this space also comes at an auspicious moment: market pressures have been easing, several countries are seriously reforming, and growth seems to be coming back on the agenda. Europe should seize this moment to move decisively to “get the ESM right” via the points just made – a critical mass of available resources; predictable and readily deployable instruments; and a governance structure that tempers national interests and is able to respond swiftly to fast-moving crisis situations.