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2013 - The ESM's Baptism of Fire

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The protracted euro crisis enters the New Year with a tenuous hope of having finally turned the corner. Those who predicted the euro's imminent demise have not only been belied by the facts, but in many cases also hit in their wallets. On the other side, though, there are those who prematurely declare victory and believe efforts can be eased. On the contrary, resolve need to be strengthened, keeping to the course taken. Not only toward banking union and the other long-term goals, but also in the management of the short-term challenges facing the European Stability Mechanism (ESM). The coming year will be the new fund's first full year of operation and its first real test on the ground.

This test does not, for once, regard Greece, where the recent agreement - though not conclusive - should at least tide matters over for the coming year. The pressing issues for the ESM in 2013 lie elsewhere. These are essentially four, and concern respectively Cyprus, Ireland and Portugal, Spain, and finally Italy (along, once more, with Spain).

In Cyprus, where negotiations have dragged on for months, the country is bankrupt, forced to borrow from public enterprises' pension funds to cover current spending. The crucial issue here is how to prevent a mega-loan to save the banks (possibly equal to 100% of the country's GDP) from raising the same issues that plagued Greece: a level of unsustainable debt and a disproportionate presence of official creditors. The need to involve the private sector in the rescue thus arises from the very start. But there is a risk that this will not be done sufficiently, ultimately requiring (as in Greece) a restructuring of debt owed to official creditors. What was successfully avoided in over 60 years of international crisis lending – namely, losses borne by official creditors (except for debt relief to the very poorest countries) – would arise twice within a short time span inside the euro area. It will therefore be essential to appropriately bail-in private creditors, wind up insolvent banks, and contain as far as possible the risks assumed by the public purse. There reportedly are divergences between the IMF and Europe within the troika on this matter, in a re-run of those seen in the Greek case.

That the troika is an unwieldy crisis management structure is evident also in the case of Ireland. One is struck here by the unusually harsh tone toward Europe used by the IMF in its latest report on the country. While a divergence of views between two official institutions is traditionally expressed in hushed tones, the IMF report released on December 19 pulls no punches. It affirms that Ireland has largely done its part and that the prospects for a return to market borrowing in 2013 now depend crucially on a "forceful delivery of European commitments" to the country. The IMF urges Europe to live up to the pledge made at end-June 2012 to improve the sustainability of the "well-performing" Irish program, and to do so via direct ESM equity participation in the troubled banks. Europe, for now, refuses, taking cover in subtle distinctions between legacy and future debts, between government and ECB responsibilities, between what can be done now and only once a single supervisor is in place, and so forth. Meanwhile, it misses the opportunity of flaunting the EU's first "success story" of this crisis. A broadly similar situation arises in Portugal, which is in vain seeking financial terms that would be at least broadly comparable to those granted Greece.

In Spain too there is a need for direct ESM bank recapitalizations, well before a single supervisor is set up. Although everyone recognizes the importance of severing the bank-sovereign linkage, here too problems are pushed back and underestimated, with severe risks.

Finally, the case of Italy - along with that of Spain - has highlighted gaps in the modus operandi of the ESM. Neither of the two countries - despite obvious political risks in the near future - has opted to take the steps necessary to activate, if necessary, the ECB's purchases of securities under its OMT program. Such reluctance stems from the uncertainty surrounding the extent of conditionality that would be attached to the ESM's precautionary facility required by the ECB to intervene. Without such clarity, which should be established as soon as possible by the ESM's governing bodies, OMTs will remain mere phantoms and their beneficial effect on markets likely to fade over time.

The longer-term success of the euro project clearly depends on further progress on the road to integration. But without a positive outcome of the specific country cases facing the ESM at the start of the year, this New Year's Eve toasts – while justified – risk soon leaving a bitter after-taste.