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Developing Europe’s financial “safety net” in a time of crisis

Abstract: *This article explains how the deterioration in public finances and the developing sovereign crisis led to the creation of a European financial "safety net". The different financial instruments (BoP, GLF, EFSM, EFSF, ESM) are the response to specific challenges and what was feasible at a given moment. The financial assistance architecture had to adapt quickly to a rapid evolution of the crisis. The roles of the IMF, the ECB and conditionality are also discussed. The article concludes that a necessary condition for the EU to overcome the crisis is better communication and a resolute deepening of European solidarity via new tools, structures, and frameworks.*

Key words: financial assistance, financial crisis, Euro Area, European Stability Mechanism.

E-mail address: javier.villar-burke@ec.europa.eu. Disclaimer: The opinions and statements expressed in this paper remain solely those of the author and do not necessarily reflect the views of the European Commission. The author would like to thank Ioana Diaconescu for her most valuable insights and assistance in completing this article; Fionnuala Bourke and Caroline Simpson for their comments to the manuscript; and Pieter Bouwen who helped gather the data on the use of the rescue mechanisms. Any remaining errors are strictly the fault of the author.

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1. INTRODUCTION

We are faced with an unprecedented moment in modern history. The globalised and interconnected nature of the world today has heightened the financial and economic crisis that began in 2007, turning what many assumed would be a blip in the history books into a protracted period of uncertainty.

For now, Europe and other global economic players will continue seeking to address challenges, to adapt to constantly changing circumstances, and manage the different stages of the crisis. What began in the financial sector has now eroded public finances and hit the real economy, affecting individuals in both developed and emerging economies. And as the various stages of the crisis have emerged or intensified, policy makers have sought to adjust solutions and deepen the response.

The European Union's reaction to the crisis has, in its own right, been unprecedented. Five years ago, it would have been inconceivable to think that half of the policy decisions taken in the past three years could be openly discussed, let alone a compromise solution agreed upon. The decisions taken clearly reflect the level of political compromise that can be reached when an initiative is backed by necessity, public opinion and momentum.

However, the pace of decision-making also reflects the difficulty of reaching consensus when solutions must take account of extremely varied points of view. The process of reaching agreement on issues as complex as those that the EU has recently tackled means long and arduous negotiations and compromise. A lot of compromise. It should also be noted that other nations or regions do not have to contend with this kind of process to the same extent. As such, we citizens – and critics alike – should acknowledge that the work and progress made since the start of the crisis is significant, even if not always perfect.

This article will focus on one of the European Union's key responses: how the deterioration in public finances and the developing sovereign crisis in some Member States led to the creation of a financial "safety net". This sovereign firewall was erected to act as a backstop, or safety net, to the plethora of initiatives (legislative, financial, fiscal, etc.) that constitutes the EU's overall response to the financial and sovereign crises. It is currently made up of the Balance of Payments Facility (BoP), the European Financial Stabilisation Mechanism (EFSM), the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). Although some of the concepts are not new, and the BoP has existed since the Treaty of Rome, this broader and more robust financial backstop was erected to complement the legislative and policy dictates emerging out of the crisis. The truly significant aspect, however, is that part of this backstop will remain in place permanently. Despite the potential shortcomings of the instruments themselves, this is progress at its utmost.

Much of public debate on the sovereign firewall has been limited and informed by a certain perspective: that taxpayers should not be held solely responsible for the failings of otherwise wealthy institutions and individuals. While this objective is not being refuted, this article seeks to go beyond that, to shed some light on the sovereign backstop instruments, provide technical details and explain the manner in which they would be used.

The structure of the paper is as follows. Each one of the instruments used as a means of providing financial assistance to EU Member States (BoP, GLF, EFSM, EFSF, ESM) is explained in one section or subsection. Sections 5.3 and 5.4 summarise the roles of the IMF and the ECB. Sections 5 and 7 put forward, on the one hand, how the instruments were adapted to changing circumstances and a worsening of the crisis beyond expectations and, on the other, the challenges faced by decision makers in rendering the instruments fully operational. The text is complemented with four boxes that explain the role of "conditionality" as a compensation for financial assistance, discuss the role of credit ratings, summarise the use of the new financial support structure so far, and present an overview of the response to the crisis on other fronts.

The conclusions presented defend the idea that a necessary condition for the EU to overcome the crisis depends on improved communication and a resolute deepening of European solidarity via new tools, structures and frameworks.

2. THE BALANCE OF PAYMENTS FACILITY (BOP): THE PRECURSOR

A European mechanism to ease Member States' external financing constraints was already foreseen at the outset of the European Economic Community in 1957[1]. This Balance of Payments (BoP) Facility was then developed in the 1970s in the context of the oil crisis.

The BoP facility is activated by a request from an EU Member State either experiencing or threatened with difficulties. Any decision to grant financial assistance via the BoP is accompanied by a macroeconomic adjustment programme designed to assist the beneficiary in achieving a sustainable balance of payments position[2].

The funds to be extended under the BoP are raised by the European Commission on behalf of the EU via international capital markets. The financial conditions obtained by the EU when raising funds are then passed on to the beneficiary Member State without adding any additional margin.

In 1988, the lending ceiling for the BoP Facility was set at ECU 16bn[3]. However, the introduction of the Euro in 1999, resulted in the BoP being restricted to only non-Euro area Member States and the lending ceiling was somewhat reduced to €12 bn in 2002[4]. Following the enlargements of 2004 and 2007 – which created an EU of 27 Member States – and the intensification of the financial crisis, the ceiling was raised to €25 bn in December 2008 and, subsequently, to €50 bn in May 2009[5]. A technical update is currently under way in order to align the BoP with all the developments that are presented throughout this paper. The new BoP Facility is anticipated to be approved sometime in the course of 2012.

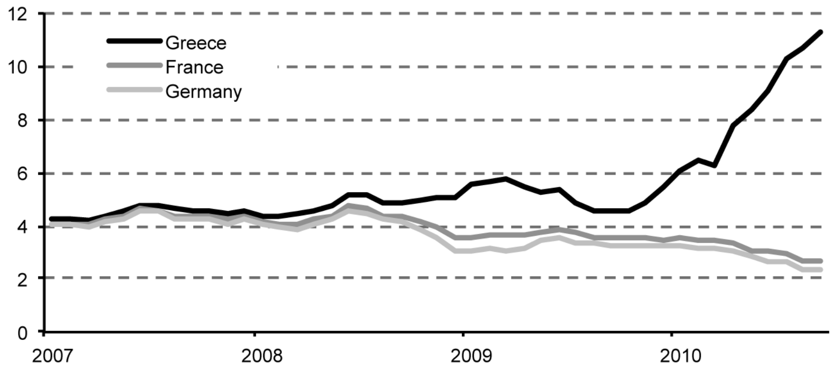
During the recent crisis, three EU Member States (Hungary, Latvia and Romania) requested financial assistance through the BoP[6]. EU financial assistance was usually coupled with support from the IMF[7].

3. THE GREEK LOAN FACILITY (GLF): AN AD HOC SOLUTION

The creation of the Economic and Monetary Union in 1999 was expected to create an area of financial stability that would mitigate risks in the balance of payments and public finances of Euro area Member States[8]. As a consequence, The BoP facility was restricted to non-Euro Area countries. While no other policy instrument was foreseen for tackling a situation of financial distress within the Euro Area, actual events showed that the risk of funding difficulties had not disappeared.

In April 2009, Greece was subject to an excessive deficit procedure, with the Commission and Council already having issued several recommendations for the Member State to improve its situation. The actual depth of the problem, however, was only revealed in December 2009 when public deficit figures were revised much higher than previously foreseen[9]. Despite the commitment of Greek authorities to do whatever was necessary to meet the targets set in the stability programme[10], the cost of Greek public debt continued to rise, indicating an even more significant loss of market and public trust in the Member State and its economy. Yields for 10-year bonds surpassed 6% in January 2010 and rose beyond 8% in April (Chart 01). Such costs, given the level of debt, became quickly unsustainable.

Chart 01: Cost of refinancing Greek sovereign debt vs. Germany and France *10-year bonds, monthly averages, yields, %*

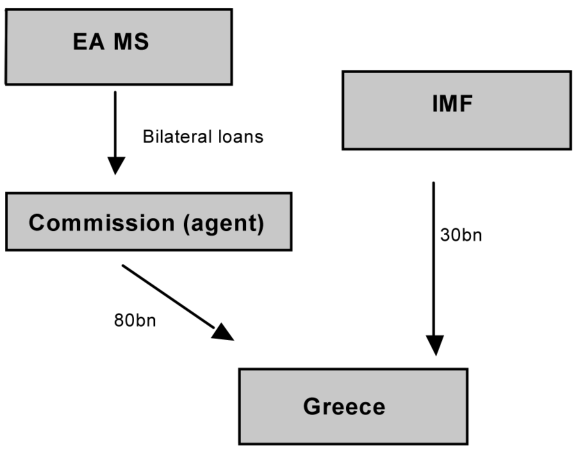


Source: Bloomberg.

While there was initially strong opposition to creating any kind of financial support mechanism, an EU rescue package turned into the only option to avoid a Greek default at the time. On 25 March 2010, the European Council discussed, for the first time, the possibility for Euro Area Member States to contribute via coordinated bilateral loans[11]. On 23 April, the Greek government officially requested financial assistance. Greek authorities negotiated with the IMF, the Commission and the ECB a programme of economic reforms that was approved by the Greek Council of Ministers on 2 May 2010. The Eurogroup endorsed the programme and agreed on the means of conducting financial assistance via the Greek Loan Facility (GLF)[12].

The GLF consisted of bilateral loans from the Euro Area Member States to Greece pooled by the European Commission, which acted as the distributing agent (Chart 02). The total amount of the GLF was €80 bn. The IMF contributed with an additional €30 bn.

Chart 02: The Greek Loan Facility (GLF)



Source: European Commission.

The financial assistance was conceived to last for a period of three years. The reforms envisioned under the macroeconomic adjustment programme aimed to improve Greece's fiscal situation as well as its economic outlook[13]. At the time, it was foreseen that Greece would regain market access in the second half of 2012.

Box 1: Conditionality: the complement to financial support

Financial assistance disbursed under the BoP, the GLF or under any of the other instruments discussed in this article, is not free. First, it always comes in the form of funds that have to be repaid and bear interest during the entire period that assistance is outstanding. In addition, it is accompanied by strict policy conditionality, which is key to ensuring that the beneficiary is able to repay its debt and that moral hazard[14] is minimized.

Economic policy conditions usually involve an agreed path of fiscal consolidation, governance measures (reform of taxation and tighter spending controls at all levels of government), as well as financial sector stabilisation measures (such as additional banking regulatory requirements) and structural reform measures to improve the business environment and support growth (for example, increasing administrative capacity to absorb EU funds more effectively)[15].

The beneficiary Member State negotiates with the European Commission and the ECB a draft macroeconomic adjustment programme to be approved by the Council[16]. During the programme's duration, which is typically three years, the European Commission and the ECB conduct reviews at regular intervals to ensure that the economic policies and reforms of the beneficiary comply with the parameters of the macroeconomic adjustment programme and the previously agreed conditions. Adjustments are sometimes made to the programme to take into account changes in the economic environment and documents are adjusted accordingly. Subsequent instalments of the loan are released only once the EU institutions have assessed and are satisfied with the beneficiary's compliance.

4. MAY 2010: MOVING TOWARDS A COMPREHENSIVE STRATEGY

At the same time that the GLF was agreed, the European Council tasked the Commission and the ECOFIN Council to engineer a more robust European stabilisation mechanism.

The main goal was to address the financial market fragility that was beginning to impair the normal functioning of sovereign markets and mitigate the risk of contagion from Greece to other potentially vulnerable Member States. Moreover, in a context in which many Member States were already experiencing fiscal problems and increasing debt positions, putting Member States in a position in which they would have to access capital markets for additional funds that could be lent on did not appear to be an appropriate solution. Therefore, it was agreed that any new financial assistance instrument, in contrast to the GLF, would have to be established in such a way as to collectively access markets.

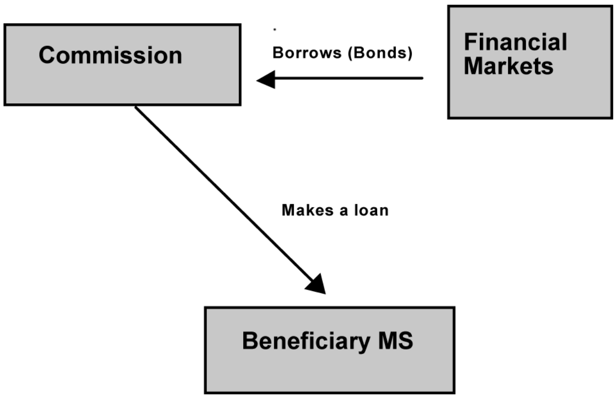
In May 2010, the Council established the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). The package was complemented by the participation of the IMF. In addition, the ECB launched unconventional measures to support financial stability.

4.1. The EFSM: a robust and cheap instrument but limited in size

The EFSM (European Financial Stability Mechanism) is a financial support instrument backed by the EU budget. It can be used by any of the 27 Member States (EA and non-EA). The conditions that the European Commission gets from international markets are passed on to the beneficiary Member State with the addition of a small fee. While the financing remains cheap, there was initially an incentive for non-EA countries to continue using the BoP Facility, which does not have a fee.

The EFSM is based on existing procedures ("community methods") and the capacity of the EU and the European Commission to enter into financing contracts. The agreement of 10 May 2010 was enshrined in a (just 3-page long) council regulation[17] and it was fully operational two days later. While initially created as a temporary mechanism, the EFSM can continue to exist as long as the exceptional circumstances threatening the financial stability of the EU as a whole – under which it was created – still exist.

Chart 03: The European Financial Stability Mechanism (EFSM)



Source: European Commission.

As in the case of the other financial assistance instruments, the use of the EFSM is subject to strong economic policy conditions with a view to preserving the sustainability of the beneficiary Member State's public finances and restoring its capacity to finance itself on the financial markets[18].

The cap for the size of the EFSM is linked to the margin available under the own resources ceiling. This ceiling of the EU budget is set at 1.31% of EU GNI[19]. However, the budget has always been below that ceiling (around 1.10% of GNI). This margin between the ceiling and the actual is the capacity that the EFSM can use, about €60 bn[20].

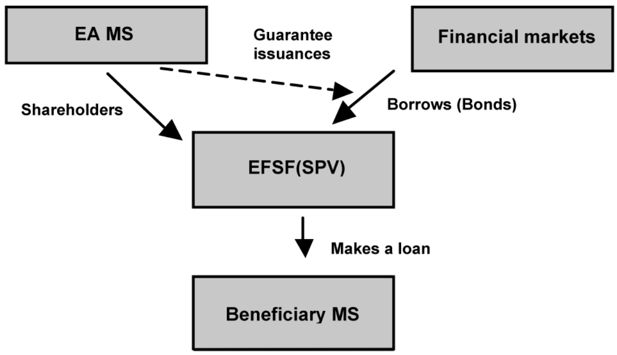
When comparing the capacity of the EFSM with the potential needs[21], the firepower appears to be rather limited. Therefore the EFSM was complemented with the creation of the EFSF and the IMF commitment to participate in EU financial assistance programmes. That said, the EFSM includes the explicit possibility to open a credit line, so that the beneficiary country can have certain flexibility to draw funds.

4.2. The EFSF: significant size but several weaknesses

The EFSF (European Financial Stability Facility) is a Special Purpose Vehicle (SPV) established by an intergovernmental agreement among all Euro Area Member States[22]. Recourse to the EFSF is restricted to Euro Area countries.

The capacity of the EFSF was fixed at €440 bn. While the previous section explained that the EFSM capacity was based on what was seen as a prudent risk backed by the EU budget, there was no such benchmark to determine the overall size of the EFSF. Given that the firepower of the IMF was $250 bn in 2008[23], policy makers considered that a total of €500bn (EFSF 440bn + EFSM 60bn) would be a sufficiently large firewall for the Euro Area.

Chart 04: The European Financial Stability Facility (EFSF)



Source: European Commission.

The EFSF was also created as a temporary mechanism, with a duration of 3 years[24]. While the EFSF will continue to exist as long as it has not completely reimbursed the bonds issued, it will no longer enter into new operations after June 2013. The implementation of the EFSF proved more difficult than initially expected.

First of all, contrary to the European Commission, the Euro Area is not a legal entity. Therefore, the EFSF had to be created as a Special Purpose Vehicle (SPV), resulting in prolonged negotiations until it was finally incorporated in June 2010. Because of significant political and budgetary implications, the intergovernmental agreement establishing the EFSF also had to undergo ratification in all participating Member States, which further delayed the process; the EFSF finally became operational on 4 August 2010[25].

Another issue around the EFSF is that Member States that apply for EFSF financial assistance stop contributing to the Facility, thereby reducing its capacity.

Thirdly, the EFSF depends exclusively on guarantees (there is no paid-in capital). As a consequence, Eurostat established that the "debt issued by the EFSF must be reallocated to the public accounts of States providing guarantees […]. It will therefore be accounted for in the government debt of States having provided guarantees"[26].

Finally, credit enhancements (over-guarantees of 120%, cash buffers and cash reserves) were foreseen to secure a higher credit rating for the EFSF and make it less dependent on the ratings of the Member States. The cash buffers and cash reserves to be fed by the beneficiary Member State implied that the country had to "overborrow" and thus take on an even greater burden in national accounts. In addition, it also meant that the effective cost of the loan was higher than the nominal interest rate[27].

The structure of the EFSF (the EFSF being only guarantee based, the fact that beneficiary countries step out as a contributors, and the credit enhancements) shrunk its effective lending capacity from the initially foreseen of €440 bn to about €250 bn.

In addition, the EFSF capital structure also had a negative impact on the mechanism's governance, rendering decision-making more difficult. The guarantee structure implies that EFSF operations have a direct impact on national budgets. This implies that several Member States have to acquire Parliamentary approval every time a programme is decided upon and, in some cases, even when a disbursement is made. The German Federal Constitutional Court, for example, considered that the measures taken by the Government with respect to the GLF and the rescue packages were compatible with the German constitution. However, it also considered that "*the Federal Government is obliged to obtain prior approval by the Budget Committee before giving guarantees within the meaning of the Act*"[28]. In practice, this meant that negotiations about any new aid granted by the EFSF have had to be subject to the approval of the Budget Committee of the German Parliament.

Box 2: Ratings and the importance of AAA

Credit ratings provide an assessment of the creditworthiness of financial issuers or financial products. The highest and most coveted rating, is the AAA. This is followed by AA+, AA, AA-, A+ and so on[29]. Ratings have a direct impact on the price of products and the interest to be paid when borrowing. The higher the rating, the lower the interest required by investors to lend.

However, the AAA-rating is not just another notch in the rating scale. Many institutional investors such as pension funds and asset managers have an obligation or mandate that restricts their investments to certain ratings, often AAA only. As a consequence, securing an AAA rating not only ensures a lower cost, but provides a wider investor base, and thus broader demand for a product, than other lower ratings.

The bonds issued by the different rescue instruments imply large volumes of debt instruments that must be sold if the necessary funds and subsequent disbursements are to be assured. In this context, some credit enhancements were introduced in the EFSF to ensure an AAA rating.

For some time, the European Commission, in line with discussions at international level, has been trying to diminish the markets' dependence on ratings and, consequently, rating agencies. Although work to introduce greater competition, improve methodologies and accountability is ongoing, no clear alternative has yet emerged. As such, financial market participants – including the EFSM, EFSF and ESM – remain dependent on the market's perception and, thus, ratings.

That being said, the recent downgrades of several Euro-area Member States and the downgrade, by a single rating agency, of the EFSF itself, has shown that non-AAA sovereign debt can still be issued at reasonable prices. Therefore, the EFSF is testing the waters with an AA+ rating in order to continue servicing its commitments and not jeopardize its lending capacity.

4.3. IMF contribution: immediately operational plus expertise

The participation of the IMF alongside the EU in providing financial assistance to European countries has been instrumental for several reasons.

First of all, the IMF has 70 years of experience in negotiating and designing macroeconomic reform programmes, while it was a new policy for the EU. We have seen that the EU BoP facility was available since the earliest stages of European integration but it had not really been used; as a result, the expertise of the IMF was an important asset.

Second, in operational terms, IMF funds were immediately available while the establishment of a totally new institutional set-up took some time in Europe. It took three months of negotiations and work to render the EFSF operational. In addition, the EU needs about two or three weeks to tap funds in the markets and conduct the on-lend operation to a beneficiary. Nevertheless, it is interesting to note that the EU has always been the one who made the first disbursement.

With respect to repayments, the fact that IMF loans are repaid in several instalments[30] smoothes out the financial burden on a beneficiary country. In the EU, loans were usually back-to-back. This implied that each EU disbursement had to be paid in full at the maturity date of the corresponding bund issued in the market. However, since November 2011 the EFSF initiated a diversified funding strategy, which may allow for greater flexibility in the repayment schedules.

Finally, being an "external" actor, the IMF could have higher negotiating power. It was thought that, given its experience and prestige, the IMF could help legitimise the reform programmes, even though IMF interventions were also embedded with a certain "stigma" and negative signalling of a beneficiary's financial stability. In any case, it was clear that the presence of an external actor would serve to put peer pressure on the beneficiary country and avoid the risk of moral hazard. While beneficiary countries needed the financial support to continue functioning, these countries knew that the rest of the Euro Area and the EU as a whole would have a direct interest in mitigating contagion and spill-over effects. The presence of the IMF, therefore, could serve to balance the negotiation power between the lenders and the beneficiaries.

The participation of the IMF in European programmes has clearly evolved over time. In the first BoP programmes (Latvia, Hungary and Romania), the IMF put 60%; in the programmes for Greece (first), Ireland and Portugal, the IMF contributed about 30% of the funds; in the second Greek programme, the IMF share was reduced to just 10% (€20 bn out of approximately €200 bn)[31]. The financial assistance for Spanish banks agreed on 9 June 2012 will come exclusively from European sources[32].

Two main reasons explain the decreasing participation of the IMF. On the one hand, this paper shows the enormous progress made by the EU not only in terms of financial and operational capacity but also in terms of expertise. As a consequence, the acute need for IMF participation has eased. On the other hand, the IMF has expressed concern about the increased concentration risk it would be taking by continuing to assist so largely countries in Europe[33]; as such, it has indicated that it prefers to decrease its involvement so long as its overall general resources do not increase proportionately.

That said, EU countries contribute to IMF resources (EU countries provide about one third of IMF funds) and they have substantially participated in the recent increase of IMF capacity.

Box 3: Recourse to the EU – IMF rescue package

Besides the programmes for non-Euro Area countries under the BoP facility (Hungary, Latvia and Romania), three Euro Area Member States have asked for financial assistance (Greece, Ireland and Portugal)[34]. An enlargement of the aid to Greece (via a second programme) was decided in November 2011. Programmes are designed for a typical duration of three years (Table B01).

Table B01: Programme dates

Programme	Start	End
Hungary	2008 (nov)	2010 (nov)
Latvia	2008 (dic)	2012 (ene)
Romania (I)	2009 (may)	2011 (mar)
Greece (I)	2010 (may)	2012 (mar)
Ireland	2010 (dic)	2013 (dic)
Romania (II)	2011 (mar)	2013 (mar)
Portugal	2011 (may)	2014 (may)
Greece (II)	2012 (mar)	2014 (mar)

Note: In the second programme, the IMF committed to support Greece for 4 years under an EFF.
Source: IMF, European Commission and EFSF

Total commitments amount to €454 bn, of which €119 bn have been committed by the IMF and €335 bn by the different European instruments and Member States (Table B02).

Table B02: Total commitments by beneficiary country and instrument
€ bn

Instrument	Beneficiary country						
	Greece	Ireland	Portugal	Romania	Hungary	Latvia	Total
EFSF	144,7	17,7	26,0				188,4
IMF	39,9	22,5	26,0	16,5	12,5	1,7	119,1
GLF	52,9						52,9
EFSM		22,5	26,0				48,5
BoP				6,4	6,5	3,1	16,0
Others		22,3		3,2	1,0	2,7	29,2
Total	**237,5**	**85,0**	**78,0**	**26,0**	**20,0**	**7,5**	**454,0**
ECB facility	35,0						

Note: Others include bilateral contributions (UK, SE, DK, FI, IE, EE, NO, CZ, PL), EIB, EBRD and WB. Initially, the GLF amounted to €80bn. €24.4 bn were transferred to the second Greek programme and €2.7 bn were withdrawn (corresponding to SK, IE and PT). Situation as of May 2012. Spain expressed its interest in applying for financial support on 9 June 2012, but details are not known yet.
Source: IMF, European Commission, EFSF and own calculations.

Commitments correspond to the expected needs for the whole duration of the programme. However, disbursements are paid in quarterly instalments. Up to May 2012, total disbursements amounted to €308 bn (€78 bn from the IMF and €230 bn from EU sources) (Table B03).

Table B03: Disbursements
€ bn

Instrument	Beneficiary country						
	Greece	Ireland	Portugal	Romania	Hungary	Latvia	Total
EFSF	73,0	12,2	14,9				100,0
IMF	21,8	16,0	18,5	11,9	8,6	1,1	77,8
GLF	52,9						52,9
EFSM		18,4	20,1				38,5
BoP				5,0	5,5	2,9	13,4
Others		22,9		2,0		0,5	25,4
Total	**147,6**	**69,4**	**53,5**	**18,9**	**14,1**	**4,5**	**308,0**
ECB facility	35,0						

Notes: Others include bilateral contributions (UK, SE, DK, FI, EE, IE, NO, CZ, PL), EIB, EBRD and WB. Irish national authorities are currently advancing €20.7 bn liquidity. This will be reduced over the duration of the programme to the initial foreseen €17.5 bn. Hungary has already repaid €3.2 bn of the amounts disbursed (€1.2 bn to IMF and €2 bn to the EU). Situation as of May 2012.

Source: IMF, European Commission, EFSF and own calculations.

The first EU loans were agreed with a maximum duration usually not exceeding 7.5 years. However, in 2011, maturities were extended to up to 30 years[35]. After the end of the programme (i.e. when disbursements are completed), countries remain under post-programme surveillance until they have reimbursed a certain portion of the loans[36].

4.4. The ECB's measures: flexibility and action on the secondary market

The May package was complemented by steps taken by the ECB to provide assistance without breaching its monetary policy mandate. The ECB established the Securities Market Programme (SMP) on 9 May 2010[37] in order to address severe tensions in financial markets (including sovereigns). Within two months, the ECB had purchased up to €60 bn of bonds under the SMP, which it subsequently de-activated when tensions eased. In summer 2011, upon a heightening of sovereign tensions, the SMP was reactivated. Holdings of bonds under the SMP were €212 bn as of May 2012[38]. The SMP was the precursor of the purchases in the secondary programme by the rescue mechanisms (see next section).

In addition to the SMP, the ECB has taken several other "non-standard" measures since September 2008 to assist in battling the financial crisis, in keeping with its mandate. In addition to reducing its central refinancing rate to 1%, ECB measures included: an increase in the frequency and size of its longer-term refinancing operations (with an increased maturity of up to one year), to provide full allotment in all liquidity-providing operations, to offer funding in US dollars and Swiss francs through foreign exchange swaps, and the purchase of euro-denominated covered bonds[39].

The main strength of the ECB is its capacity for prompt action and a virtually unlimited size. For instance, between December 2011 and February 2012, the ECB injected over one trillion Euros in Euro Area banks through two 3-year longer-term refinancing operations. This is twice the size of the combined capacity of ESFM and EFSF. However, ECB action is restricted to monetary policy and it has to respect its mandate of controlling inflation and not to monetise government debt. This means that the ECB can ease the symptoms (stress in financial markets) but it cannot address the roots of the crisis (structural imbalances). This is why it is often said that the ECB can provide time but the real solutions can only come from determined policy actions by governments.

5. EXPANDING THE TOOLBOX AND IMPROVING THE EFSF

Box 3 shows the Euro Area programmes approved by May 2012. The size of those programmes is calculated on the basis of the financing needs of the beneficiary Member States for the duration of the programme. While the crisis has evolved, this method appeared to be too restrictive and greater flexibility was needed. The "toolbox" of instruments was, therefore, expanded beyond the traditional loans to Member States to address various needs and cases.

1_*Credit lines*. Credit lines (of which there are two types, one with only ex-ante conditionality (and continuous respect of it), another that requires only certain corrective measures) are intended to serve a precautionary need and act as a crisis prevention tool rather than a regular crisis resolution instrument. They require lighter procedures and foresee a swifter implementation process. They are provided for countries with sound economic policies and fundamentals but facing a "risk of future problems in maintaining access to market financing at reasonable terms". Once a credit line has been activated, the beneficiary Member States can request the draw-down of funds via a simple loan or a primary market intervention at any time during the availability period[40]. This tool was inspired by the credit lines available at the IMF, in order to provide for more preventative means of financial assistance and mitigate the large stigma that comes with a macroeconomic adjustment programme. A variation of this idea is available under the BoP, where a precautionary loan can be granted –like that given for the second Romanian programme (see Box 3), on which no disbursement has yet been made.

2_*Purchases in the secondary market*. Before reaching a situation of actual insolvency, some countries may face a dysfunctional bond market. It was decided that the European firewall should be able to intervene in such cases without demanding a fully fledged macro-economic adjustment programme[41]. Beneficiary countries will be subject to ex-ante eligibility conditions and some corrective actions[42]. The ECB's purchases under its SMP served as an example of this tool (see Section 4.4).

3_*Purchases in the primary market.* This is a tool that would likely be used primarily towards the end of a programme to assist in a beneficiary's re-entry into the markets. The rescue mechanism will buy bonds in the primary market or via placements with private investors. The goal is to restore the relationship of the beneficiary country with the investment community and support market access. Purchases in the primary market will also be possible for countries under a precautionary programme[43].

4_ *Bank recapitalisation*. The losses incurred by some banks and their weak capital position played a significant role in the current financial crisis and served as a key source of financial stress. In many countries, the State had to intervene to rescue vulnerable banks[44]. As a result, a new tool was conceived to allow the rescue mechanisms to provide a loan to a non-programme Member State for the purpose of recapitalising financial institutions. Such funds require that clear eligibility conditions are met, and are accompanied by institution-specific and other horizontal conditionality in order to address vulnerabilities, restore viability as well as financial stability[45]. This instrument will be first used by Spain[46].

In parallel to the increased flexibility of the instruments, there was a debate about how to maximize and get the most out of existing resources as well as the adequacy of the firewall's size. As discussions continued on the design of the permanent mechanism[47], two options were developed to enlarge the EFSF's capacity without increasing Member State guarantees. This was proposed through two "*leverage*" options for the EFSF.

The first option was for the EFSF to issue *sovereign partial protection certificates*. The beneficiary country would issue bonds in the market and the EFSF would guarantee the first 20% or 30% of the losses[48]. A second option was the creation of *co-investment funds* which would pool public funds with additional/parallel participation of private investors[49].

An amended EFSF2 entered into force in October 2011 after ratification by all 17 Member States. Amendments to the EFSF included the four new instruments as well as the leverage options. In addition, the effective capacity was raised to €440bn by increasing the over-guarantees to 165%[50]. The expanded toolbox will also apply to the ESM (see Section 6). The leverage options, however, will remain restricted to the EFSF.

Box 4: Beyond the financial "safety net": a comprehensive response to the crisis

This paper shows the framework established in the EU to set up a financial safety net as a crisis resolution tool. However, the response to the crisis was much wider. Many far-reaching decisions were made to mitigate the flaws that led to the crisis and to deploy the means for fostering stability and growth. The *roadmap to stability and growth* presented by the European Commission in October 2011[51] compiled many of the decisions that had been taken and put forward a list of elements that need to be urgently implemented "in order to restore confidence in the Euro Area and the EU as a whole".

First of all, a decisive response to the problems of Greece was needed. It included the negotiation of a second adjustment programme with the participation of the private sector (see Section 7.7)[52].

Second, the initial backstops against the crisis needed to be enhanced. This led to the revision of the "toolbox" of instruments and the maximisation of the EFSF's firepower (see Section 5) as well as to the advancement of the ESM's entry into force (see Section 6.1).

Third, the banking system needed to be strengthened. Huge efforts, both in regulatory and financial terms, have been made from the earliest stages of the crisis to strengthen Europe's banks. Although not exhaustive, measures include the creation of supervisory authorities at European level, the proposal of the Credit Requirements Directive / Regulation to increase the capital banks must hold, an increased protection of citizens' bank deposits, restrictions related to remuneration policies, the Stress Test for banks, revising the regulation on Credit Rating Agencies and introducing a proposal for a financial transaction tax. In 2011, the European Banking Authority (EBA) coordinated a "capital exercise" requiring some banks to strengthen their capital by June 2012.

Fourth, a more robust and integrated economic governance needed to be built. With the adoption of the European Semester and the "six-pack", Member States agreed to strengthen economic policy coordination and to intensify the surveillance of economic and fiscal policies. Member States will have to send their national budgets for EU approval before adopting them. In addition, the EU will monitor macro-economic imbalances in Member States and will ask for corrections if needed.

Finally, a strategy for growth is needed to create jobs and push the EU out of the crisis. Besides better implemention of some of the existing legislation, targeted investment at EU level is being proposed. The areas foreseen include network industries, the digital agenda, innovation, "green" growth, infrastructures and strengthening employment policies.

In the countries which need these growth policies the most, public finances have been dramatically affected by the crisis. These countries do not have another option but to reduce their debt and deficit levels. However, a series of alternative sources are in the process of being discussed and implemented. They include more targeted EU structural funds, the "Connecting Europe Facility"[53], project bonds[54], increasing the lending capacity of the EIB or introducing a financial transaction tax as a source of revenue for growth. The possibility of common issuance of debt by Euro Area Member States, i.e., Eurobonds or Stability bonds, is also on the agenda for discussion.

The EU and the Member States have responded to the crisis with far-reaching decisions and measures. While some time is needed for the full impact of the measures to be effective, the extent of the decisions will only become clear in the medium term. These measures do not mean that momentum for reform has come to an end; on the contrary, the Commission continues to work on updating the plan to comprehensively address the crisis.

6. THE ESM: A PERMANENT AND ROBUST INSTRUMENT

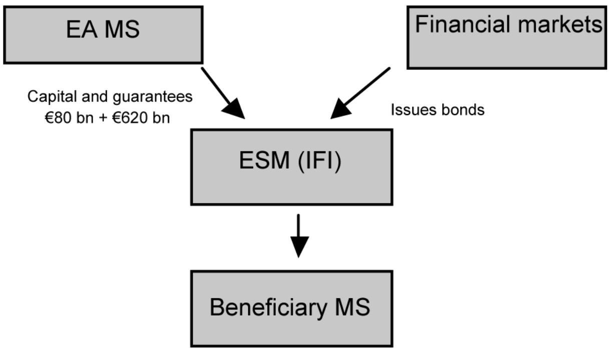
The discussions leading to an improved EFSF2 left, nevertheless, some issues unresolved:

- What to do beyond June 2013 when the EFSF is not allowed to engage in new operations.
- How to break the link between the EFSF borrowing operations and the public debt of Member States.
- How to address weaknesses in securing and maintaining the AAA rating and the dependence on Member States' ratings.

These questions, which could not be addressed with yet another amendment of the EFSF, were the driving force behind the structure of the European Stability Mechanism (ESM) and its creation as a permanent financial backstop. The first official reference to the ESM appeared in the conclusions of the European Council of October 2010. Subsequently, discussions on improvements to the EFSF ran in parallel with the design of the ESM.

The ESM was conceived as an International Financial Institution enshrined in an international treaty[55]. The ESM was initially set to start operating in July 2013, so that it would smoothly take over EFSF activities and so that enough time would be allowed for the ratification process to be completed in all Member States.

Chart 05: The European Stability Mechanism (ESM)



Source: European Commission.

The ESM's main feature is €80 bn of paid-in capital with an additional €620 bn of callable capital. This structure not only makes the ESM the largest international financial institution in the world, but also provides several key benefits. First, the debt stemming from ESM borrowing operations[56] will not be rerouted to the Member States[57]. Second, it provides a buffer to absorb losses making the ESM more robust against downgrades than the EFSF[58]. Finally, the paid-in capital provides for an up-front liquidity buffer that allows for quick interventions without the need to borrow on the markets, when an emergency warrants it.

The AAA capacity of the ESM is estimated to be €500 bn[59], equivalent to the combined capacity of the EFSF and EFSM. The paid-in capital will be disbursed in five equal instalments. An initial ESM Treaty was signed in July 2011, but work to amend it was quickly enacted in order to enhance the mechanism's flexibility, and expand its toolbox in parallel with that of the EFSF (as explained in Section 5). A revised version was signed in February 2012.

6.1. Advancing the entry into force of the ESM

While the ESM was initially scheduled to start operating in July 2013, due to its various advantages with respect to the EFSF, the entry into force was pushed forward to summer 2012 (as soon as 90% of the countries would have ratified it). As a consequence, the EFSF and the ESM are expected to overlap until end of June 2013.

A debate about the need to enlarge the size of both the EU and the global financial safety net was launched in late 2011[60]. While €500 bn seemed appropriate for supporting small- or medium-sized Euro Area countries such as Greece, Ireland or Portugal, this amount appeared to be insufficient for larger Member States, as the EU as a whole began to experience a deteriorating financial outlook.

In parallel, there was a debate about what would happen once the ESM entered into force: should the EFSF stop providing support?; would both instruments work in parallel?; should the unused capacity of the EFSF be added to the ESM?; should it be done on a temporary basis or permanently?

The Eurogroup of 30 March 2012 set the combined EFSF/ESM capacity at €700 bn. While the EU has created a firewall larger than any other financing arrangement in the world, able to mobilize almost €900 bn when you combine all of the various instruments (BoP, GLF, EFSF, EFSM, and ESM), this amount still seems to be below market expectations[61]. After the Eurogroup decision, financing conditions in peripheral Euro Area countries (including Spain and Italy) did not improve. Therefore, the issue of the size of the Euro Area safety net may not be closed yet.

7. MAKING THE DECISIONS OPERATIONAL: NEGOTIATING THE DETAILS

"*The Commission would have preferred bolder and quicker decisions. But our Union works on the basis of compromise […] and it takes time. But it is worth it. This is the time needed for a genuine democratic process*"[62].

The EU is often blamed for the long time needed to adopt and implement its decisions. The challenges of achieving consensus and/or a necessary compromise are clearly visible in the process that was required to finally agree the first Greek package. That said, it is important to note that the GLF and both temporary stabilisation mechanisms were agreed to within just a few days. The agreements reached illustrate the kind of momentum that can sometimes stem from a dire need to resolve a problem for the good of the whole; a momentum that is not always easily found in times of prosperity when each Member State, in its own right, is progressing and experiencing growth.

This section tries to give a flavour of the challenges confronted not only when trying to reach these agreements about the general framework presented throughout this paper but also for deciding about the details that make them operational. This will help explain why it takes time.

7.1. Who is involved in the process?

The heart of the crisis focused on the Euro Area and, therefore, many of the decisions were taken only by the Member States sharing the common currency. However, many of the decisions can have spill-over effects on non-Euro Area countries, so that they need to be involved in the discussions. For instance, the creation of the EFSM and the change in the Treaty on the Functioning of the EU needed the participation of the 27 Member States. While the ESM was only signed by Euro Area countries, all 27 Member States were involved in the negotiation phase.

In addition, when providing assistance, the whole of the financial envelope needs to be distributed between the EFSF and the EFSM. This distribution has implications in terms of who the guarantors are (Euro Area countries or the EU as a whole) but also in terms of the costs for the beneficiary (the EFSM was initially cheaper than the EFSF) and what remains for future needs[63].

7.2. Interest rate compensation for high yield countries

Under the GLF, lenders would have to borrow in the markets in order to transfer the funds to Greece. What would happen if a country had to pay a higher interest rate to investors than what it receives from Greece? If the funds provided came from the general budget of the country without a direct connection with a specific bond issuance, how would the cost be defined?

To address this issue, a compensation mechanism was put in place. The receipts obtained from Greece beyond the cost of borrowing would be first used to compensate the countries with high borrowing costs. The rest will be distributed among the countries with lower borrowing costs.

7.3. Cost and duration of the loans

The EU set a completely new framework and few benchmarks existed prior about the appropriate rates and maturities. The interest rates needed to be sufficiently high to cover the costs but also low enough to be affordable for the beneficiary countries. The maturity needed to be long enough to allow beneficiary countries to recover from the crisis and generate the funds to repay the loan, but it should not engage the lending countries longer than needed. In addition, financial markets could impose certain restrictions[64].

In this context, since the establishment of the GLF and the EFSF in May 2010, interest rates were reduced and maturities extended on several occasions[65]. This was the result of the adaptation to a quickly changing environment and the worsening of the crisis further than expected. However, the new EFSF architecture was also instrumental for providing greater flexibility in terms of rates[66] and maturities[67].

7.4. The contribution key

Once the total envelope was established, Member States needed to decide how to allocate the guarantees and capital among themselves, i.e., the contribution key. It was an easy task for the "community" instruments, the BoP and the EFSM, as they were implicitly subject to the allocation through the EU budget.

However, for the EFSF and the ESM, there were many possibilities: population, GDP, the votes in the Council of the EU, the ECB key, the IMF key… For the EFSF, the ECB capital subscription key was considered a good compromise[68]. The ESM would be a permanent mechanism and some delegations did not feel comfortable with the ECB key. A compromise was reached through a transitional compensation to countries with low GDP per capita[69].

7.5. Voting rules

Commitments by rescue instruments could have a significant impact on national fiscal positions. However, imposing the need for unanimity for all decisions could endanger the functioning and effectiveness of the financial safety net.

A balanced compromise was reached in the revised ESM Treaty. Most decisions will be taken by mutual agreement but an emergency procedure, requiring just a qualified majority of 85% of votes cast, is also foreseen. The use of this procedure is subject to certain conditions.

7.6. The private sector involvement (PSI)

Between 2007 and 2011, Greek government debt increased from 107% of GDP to 165%[70] and it was forecasted to reach almost 200% in 2012[71]. In this context, the public financial support appeared insufficient to put the Greek government debt on a sustainable track; the participation of private bondholders became essential to ensure a reduction in the debt[72].

The PSI implied not only a reduction in the nominal amount of debt but also rescheduling the maturities and reducing the coupons. The initial agreement of summer 2011 was never implemented. In February 2012, a new agreement was reached. The face value of the bonds would be reduced by 53.5%[73]. With the maturities extended up to 30 years and the reduction in the coupon, the bonds were estimated to lose around 80% of their value[74]. The debt exchange was implemented in March and April 2012. The goal is to ensure that a government debt level of around 120% of GDP will be reached by 2020[75].

The implementation of the PSI opened the door to further relief of the debt. The revenues stemming from the Greek holdings under the SMP will be passed to Greece to further improve the sustainability of its public debt[76].

7.7. Preferred creditor status

Some more technical issues also needed to be solved. One of them was the inclusion of a clause of seniority of the rescue loans over other types of debt[77]. It seemed reasonable to get a preferred creditor status (PCS) as the rescue instruments would intervene when any other financial sources were not available[78]. However, this clause could jeopardise a smooth return to the markets by beneficiary countries. New issuances by the country could be considered subordinated and, therefore, the interest rates asked to borrow would be higher than under normal circumstances.

The PCS was introduced in the ESM[79]. The interventions in the primary market could be seen as a mitigation measure as they allow the ESM to sell the bonds at a later stage and reduce its "senior" share on the total debt of the beneficiary country. Nevertheless, investors have given a negative reaction even for reduced amounts of debt issued with PCS. Another way of mitigating an excess of preferred debt is through the issuance of sovereign partial protection certificates[80]. However, this is restricted to the EFSF.

8. CONCLUSIONS

"*Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity*", Schuman declaration, 9 May 1950.

For five years now, the EU has sailed through turbulent waters. It has remained on a weak equilibrium between a blame attitude and an increase in solidarity. It is not the first time in history that European countries have blamed each other, nor the first time that they have tried to tackle their problems together. Among the many examples of these two attitudes, it is worthwhile to highlight two critical moments for the configuration of what Europe is today.

At the end of World War I, the "winners" pointed the finger at the "losers" and obliged them to compensate for all the damages of the war[81]. There is a wide consensus that the pressure of these "reparations" played a major role in the outbreak of World War II. On the other hand, the attitude after World War II was totally different. Besides the reconstruction driven by the Marshall Plan, the ECSC was created with the goal of making war between Member States impossible by pooling together their resources[82].

Europe is currently at a crossroad. In order to choose the right direction, countries need to move beyond blaming each other and learn from the EU founding fathers. Only by avoiding isolating some countries and admitting that the current situation stems from common mistakes, will the crisis be overcome. In addition, the EU is not constituted by states but by people. The circumstances and decisions need to be properly communicated and explained to the population at large; and politicians need to involve the citizens as an essential part of the solution.

Public opinion has created a substantial amount of negative sentiment surrounding the creation and use of the rescue mechanisms building on the perception that the whole EU is now paying for the past excesses of Southern countries[83]. Many citizens from several EU countries feel that they are pouring money into vulnerable States but the citizens of these beneficiary Member States do not feel that they are being helped. Some citizens, for example, avoid travelling to Greece due to fears about their safety. Something seems to not be working properly. We are definitely not heading in the direction of uniting people, as advocated by Jean Monnet[84]. Although what has been achieved so far is enormous, weaknesses in communicating EU policies need to be addressed. This paper intends to contribute to the understanding of what has been done to address the crisis.

Latvia is an example of good communication. Prime Minister Dombrovskis took office in early 2009. After approving a tough austerity plan, he was re-elected in 2010[85]. The reform programme was implemented without needing to draw on the final tranches of IMF-EU funds. Latvian authorities put a lot of effort in communicating the situation and the actions that needed to be taken. Now, Latvian authorities are expecting the domestic economy to improve and are still working towards enabling the country to join the Euro Area in 2014. Other European leaders need to significantly improve how they communicate not only with their citizens but also with its European partners.

The wave of government changes across Europe indicates that public authorities were unable to explain the decisions they took and why they did so to their citizens. Communication, involvement and ownership of the policy decisions by the citizens are crucial elements in accomplishing the aim of the EU: to promote peace, its values and the well-being of its peoples[86]. Citizens are asking to be part of the solution as peaceful social movements like 15-M or "Indignados" show.

The role of citizens is twofold. On the one hand, they can "ratify" the decisions and ensure their long term viability. They can also put decisions in danger with their votes as was the case after the April 2012 elections in Greece, when extreme parties won significant representation and no government could be agreed.. On the other hand, people are the main asset to solve the crisis. Financial markets require stability and confidence. When citizens feel that there is light at the end of the tunnel, they will start to consume and invest, companies will hire new employees and entrepreneurs will dare to embark on new adventures. Otherwise, they will continue to restrict their expenditure and withdraw their money from the banks for fear of a collapse. Financial markets read the feelings of the population.

This paper has demonstrated how the European Union's reaction to the crisis has been unprecedented. Compromise solutions were agreed on issues that could not even be openly discussed a couple of years ago. However, in late June 2012, we were still in the crisis, and in an acute phase of it. Anything could come out of the second round of Greek elections, ranging from stronger steps towards a solution within the Euro Area to a disorderly exit of the monetary union with unknown effects for Greece and beyond[87].

The work and progress made since the start of the crisis is significant, even if not always perfect. The initial EFSF imposed not only very high rates but also that interests be paid in advance[88]. This structure was based on the one hand, "on the perception that the whole EU was now paying for the past excesses of Southern countries"[89] and, on the other, the lack of confidence in the ability of the country to repay the loan. This blame attitude is building a sentiment of resentment within Europe and putting at risk a harmonious coexistence of European peoples for the future. The consequent reductions in rates and the extension of loan maturities[90] were a true expression of European solidarity.

The decision to transfer back to Greece the revenues from the SMP and the bonds held by central banks[91] was another act of European solidarity. However, most Member States are showing some reluctance in implementing it. European solidarity is undoubtedly behind the huge amount of funds to be pooled in the ESM, even if some timidity appeared when there was a need to increase the size of the European financial safety net (see Section 6.1)[92]. Additional opportunities for "de facto solidarity" are embedded not only in the growth strategy and, in particular, in the alternative sources of funding growth[93] but also in the "Euro bonds".

European leaders need to convince themselves and their citizens that the solution will come only through a resolute deepening of European solidarity via new tools, structures, and frameworks. Leaders and citizens have, now more than ever, the opportunity to follow Schuman's vision: "*World peace cannot be safeguarded without the making of creative efforts proportionate to the dangers which threaten it*".

Notes

1 Treaty of Rome, art. 103.

2 Further technical details about the functioning of the BoP can be found in European Commission (2012a).

3 Council Regulation (EEC) No 1969/88, Art. 1.

4 Council Regulation (EC) No 332/2002, Art. 1.

5 Council Regulation (EC) No 1360/2008, Art. 1 and Council Regulation (EC) No 431/2009, Art. 1. In real terms, taking into consideration the evolution of prices, the ceiling of 2008 was equivalent to the ceiling established in 1998.

6 See Box 3 for further details.

7 See Section 4.3 for further details about the role of the IMF.

8 It was foreseen that excesses in fiscal policy of Member States would be monitored and corrected through the Stability and Growth Pact (SGP). The "no-bail out" clause would avoid a situation of moral hazard between Member States.

The SGP refers to the surveillance of budgetary positions, the coordination of economic policies and the implementation of the excessive deficit procedure. The SGP is currently enshrined in articles 121 and 126 of the Treaty on the Functioning of the European Union (TFEU) and in its Protocol No 12.

The "no-bail out" clause is Art. 125 of the TFEU: "A Member State shall not be liable for or assume the commitments […] of another Member State".

9 At the moment of the ECOFIN meeting of 16 February 2010, the Greek deficit was estimated in 12.7% of GDP. The final figure would be 15.8%.

10 Statement by the Heads of State or Government of the European Union, 11 February 2010.

11 Statement by the Heads of State or Government of the European Union, 25 March 2010.

12 Statement by the Eurogroup, 2 May 2010.

13 See Box 1 for details about Conditionality.

14 Moral hazard is the idea that providing funds (or bailing out) implies no bearing of responsibility or accountability for the receiver.

15 European Commission (2012a).

16 The adjustment programme is enshrined in a Memorandum of Understanding (MoU) and a Loan Agreement concluded between the European Commission and the beneficiary country. For further details, see in European Commission (2012a).

17 Council Regulation (EU) No 407/2010.

18 For details about Conditionality, see Box 1.

19 1.31% of EU GNI is the ceiling for commitments while 1.24% of EU GNI is the ceiling for payments. Council Decision 2007/436/EC, Euratom, Art. 3.

20 This estimate of a capacity of €60 bn takes into consideration that the repayments can be spread over several years.

21 For instance, we have seen that the first programme for Greece (see Section 3) was €110 bn (€80 bn from the GLF and €30 from the IMF).

22 European Council (2010).

23 International Monetary Fund (2012e). From 2008 to 2012, there were some reforms within the IMF leading to an increase of its capacity to $750 bn. See section 4.3 for further details.

24 See Council Conclusions of ECOFIN meeting of 9 and 10 May 2010, 9596/10 (Presse 108).

25 As indicated in previous section, the EFSM was fully operational after a couple of days following the approval of the Council of the EU and the European Parliament. In addition, the EFSM regulation was just 3 pages long while the EFSF framework agreement is over 30 pages long and the EFSF Act of incorporation is 25-page long.

26 Eurostat Decision 13/2011 of 27 January 2011.

27 The nominal interest rate would be applied to the over-borrowed amount. When the interest payments are compared with the effective amount borrowed, the effective rate almost doubled.

28 German Federal Constitutional Court, Press release no. 55/2011 of 7 September 2011.

29 Nomenclature varies among the three key rating agencies: Fitch, Moody's, Standard & Poors.

30 Depending on the instrument used, IMF loans are repaid in 8 quarterly instalments (Stand-by Arrangement (SBA), International Monetary Fund (2012b)) or in 12 semi-annual instalments (Extended Fund Facility (EFF), www International Monetary Fund (2012c)).

31 See Box 3 for further details about the financial envelope of the programmes.

32 See Eurogroup statement on Spain, 9 June 2012. For details about the funds for recapitalisation of banks, see Section 5.

33 "As of March 28, 2012, the IMF […] currently has devoted over 64 percent of total disbursing and precautionary commitments to Europe as a whole", International Monetary Fund (2012d).

34 In addition, Spain and Cyprus request EU assistance on 25 June 2012. At the time of writing, the details in terms of amounts, duration and conditions are not known as the negotiations have just started.

35 See Statement by the Heads of State or Government of the European Union, 21 July 2011.

36 For instance, in the context of article 11 of COM(2011) 819 final, which is currently being discussed under the ordinary legislative procedure in Council and Parliament, a reimbursement of 75% is foreseen for EFSF, EFSM and ESM supports.

37 Decision ECB/2010/5.

38 European Central Bank (2012b).

39 European Central Bank (2009b), pp. 9-10.

40 European Financial Stability Facility (2011b).

41 Secondary market purchases are also possible under a normal adjustment programme.

42 European Financial Stability Facility (2011c).

43 European Financial Stability Facility (2011d).

44 In January 2012, cumulative capital injections by public authorities amounted to €282 bn in the EU and €192 bn in the Euro Area (source: European Commission).

45 European Financial Stability Facility (2011e).

46 See Eurogroup statement on Spain, 9 June 2012.

47 See next section.

48 European Financial Stability Facility (2011g).

49 European Financial Stability Facility (2011f).

50 The over-guarantees imply a theoretical capacity of €780 bn. With the increase in over-guarantees, the cash reserve and the loan specific cash buffer are no longer required. European Financial Stability Facility (2011a).

51 COM(2011) 669 final. See also European Council conclusions 16 and 17 December 2010 and COM(2012) 299 final.

52 At the moment of writing these lines, the Greek situation (and the Euro Area) is in an impasse after the legislative elections of May in Greece. No agreement was reached to form a government and new elections have been called for 17 June 2012.

53 This is a proposal of the Commission of an European envelope to finance infrastructures. See COM(2011) 676.

54 See CCOM(2011) 500 and COM(2011) 660.

55 In order to allow for a permanent mechanism to be established, article 136 of the TFEU was also amended by the European Council Decision 2011/199/EU.

56 In terms of capital.

57 However, the disbursement of the paid-in capital has to be financed up-front.

58 Contrary to the EFSF, all Member States will always contribute to the ESM capital, even those requesting financial assistance.

59 Due to its structure, the AAA-rated capacity is calculated as the total paid-in plus the callable capital guaranteed by AAA and AA countries. In addition, the paid-in capital has to be maintained at a level of least 10% of the subscribed capital (requirement of the rating agencies) and the paid-in capital has to be maintained at a level of at least 15% of the borrowing operations (requirement of the ESM treaty).

60 See, for instance, the Financial Times of 6 December 2011: *EU talks on boosting financial firewall* or the Financial Times of 19 January 2012: *The IMF request $500 bn for bail-out loans*.

61 See, for instance, Bloomberg news of 29 March 2012: EU nears one-year boost in rescue fund to $1.3 trillion.

62 Barroso (2012)

63 For instance, the capacity of the EFSM has already been pledged to a large extent.

64 See for instance the discussion on credit enhancements for the EFSF in Section 4.2.

65 For instance, the European Council of the Euro Area decided on 11 March 2011 that the "pricing of the EFSF should be lowered to better take into account debt sustainability of the recipient countries" and that the interest rate on the loans to Greece "will be adjusted by 100 basis points" and the maturity increased to 7.5 years. On 11 July 2011 it extended the maximum EFSF maturities to 30 years and further lowered the interest rates of the EFSF. In addition, the maturities of the GLF were substantially extended.

The Eurogroup of 21 February 2012 stated: "All Member States have agreed to an additional retroactive lowering of the interest rates of the Greek Loan Facility so that the margin amounts to 150 basis points".

66 In particular, the increase of overguarantees to 65%. See Section 5 for further details.

67 Since November 2011, the EFSF has started a *diversified funding strategy* using a liquidity buffer and a short term bill programme. This was only feasible once the EFSF has issued enough bonds for investors to build a yield curve.

68 The ECB capital key is calculated as a combination of population and GDP. It can be considered as the "share" of a country in the Euro Area.

69 See ESM Treaty for details.

70 European Central Banks (2012d), Table 11.9.

71 See European Commission (2012e).

72 The debt crisis of Mexico and other Latin America countries only ended when American banks gave some form of debt relief to indebted developing countries. Krugman and Obstfeld (2009), page 634.

73 MoU of 1 March 2012.

74 The CDS auction established that bondholders had received 21.5% of their previous value. http://creditfixings.com/CreditEventAuctions/results.jsp?ticker=GREECE

75 MoU, page 4.

76 Eurogroup statement of 21 February 2012.

77 Another example of a technical issue was weather to include a Collective Action Clause (CAC) in national issuances. Under a CAC, a majority of bondholders may take some decisions under certain circumstances that would also apply to all other bondholders. This clause was activated within the context of the Greek PSI.

78 On the other hand, it was not clear how defendable it would be under international law.

79 The ESM would still be subordinated to the IMF. ESM Treaty, recital 13.

80 See Section 5.

81 The Treaty of Versailles (1919) states in article 231: "*Germany and her allies [are responsible] for causing all the loss and damage to which the Allied […] have been subjected as a consequence of the war*".

82 See Schuman declaration (1950).

83 See Krugman (2012).

84 "*We are not bringing together states, we are uniting people*", Jean Monnet, 1952.

85 http://fr.wikipedia.org/wiki/Valdis_Dombrovskis.

86 Treaty on the EU, art. 3.1. Furthermore, art. 3.3 estates: "*The EU […] shall work for the sustainable development of Europe based on balanced economic growth and price stability, […] aiming at full employment and social progress. […] It shall promote economic, social and territorial cohesion, and solidarity among Member States*".

87 N.B.: The second Greek elections were held after writing these lines.

88 See Section 4.2.

89 See Krugman (2012).

90 See Section 7.3.

91 See Section 7.7.

92 Recently, the author had to calculate which would be the impact on the contribution to the ESM if Latvia and Lithuania were to join the Euro Area. One would not expect that, given what is going on, an enlargement of the Euro Area to Latvia and Lithuania would keep some Member States awake (Latvia and Lithuania would jointly represent 1% of an expanded Euro Area).

93 See Box 4.

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