A Commentary on the Newly Signed European Stabilization Mechanism

Sony Kapoor, Managing Director, Re-Define (www.re-define.org)

In December 2010, Re-Define produced one of the first blueprints for the European Stabilization Mechanism "An Optimal Design for the ESM" targeted at EU policy makers. After more than six months of discussions and political wrangling, today the ESM treaty will be signed in a ceremony in Brussels. Now is an ideal time to evaluate the final shape of the ESM and to compare it to our blueprint. This short policy commentary, part of our new series of publications, aims to do exactly that. The italics highlight the proposals Re-Define made, while the normal text shows what the ESM treaty actually provides for.

The legal form

Re-Define suggested that though it may be preferable embed the ESM in the legal structure of the EU (as is the case for the European Investment Bank), it was probably much easier to set it up as an international financial institution based on an intergovernmental treaty between Euro area member states using the EBRD as a model.

This is the model the Euro area member states have chosen and the ESM will be set up as a treaty based international financial institution located in Luxembourg with Euro area member states as members.

The size

Re-Define suggested that the ESM should have a lending capacity that is enough to meet around a third of the Euro area's sovereign issuance for a period of two years – between Euro 600 bn and Euro 750 bn. We also suggested that an upward flexibility should be included in the agreement in case of contingencies.

Euro area member states have agreed on a continuation of the Euro 500 bn size agreed for the EFSF/EFSM combination so the ESM will have an initial lending capacity of Euro 500 bn. There is a provision for an upward revision but only under an onerous decision making process of mutual agreement which implies unanimity without taking into account abstentions so gives all Member States a de facto veto.

The capital structure

Re-Define proposed a three-tier capital structure comprising: 1) initial paid in capital of 1%-2% 2) substantial callable capital making up most of the balance of the overall size and 3) own resources that we suggested could be accumulated from profits, fines on member states as well as transfers of profits from the EFSF and taxes on the financial sector. We had rejected the idea of the 'joint and several' guarantee proposed by several commentators. It is unnecessary, detrimental and risky for the smallest member states.

The Euro area member states have decided: 1) an initial paid in capital of around 2% of the total amount rising up to more than 10% of the total to Euro 80 billion in five years from 2013 onwards 2) the balance in the form of callable capital and 3) a reserve fund that will accumulate fines and profits.

Member states have acted much beyond our suggestion for the proportion of paid in capital but have excluded the possibility of raising funds from the financial sector taxation in the absence of political agreement on the issue. They have rightly rejected the idea of a joint and several liabilities with the liability of each member state being limited to its share of the paid in and callable capital.

Credit rating and funding needs

On the grounds of efficiency, Re-Define recommended that the ESM aim for an AA rating since it would require a much lower capital commitment from member states; and because the cost of borrowing for AA entities is not much higher than that for AAA entities. We had anticipated that the Euro 440 bn commitments of the EFSF would provide a sufficient capital base for a Euro 750 bn implying a leverage of 1.7 times.

In the end, member states have decided on an AAA rating for reputational reasons and have committed a capital of Euro 700 bn with a substantial component paid-in upfront and an implicit leverage of only 0.71. One advantage of this over-guarantee is that the effective size of the ESM could be increased without any increase in capital commitments.

Preferred creditor status

Re-Define recommended that the preferred creditor status of the ESM be enshrined in Community law with a reference in the treaty as a second best option. Furthermore we suggested that the date of the activation of the ESM should be seen as a cut-off date with any subsequent private sector lending treated as pari passu with the ESM in order to encourage new lending by the private sector.

Euro area member states have chosen the weaker option of the reference to the preferred creditor status in the founding treaty. Also, it makes no explicit provision for the differential treatment of pre and post ESM activation lending by the private sector though such as provision could be included in the relevant MoU signed with member states accessing the ESM.

Inexplicably, the ESM makes an exception in its preferred creditor status for Ireland, Portugal and Greece the countries that are already in a program. This was presumably done in order to encourage voluntary private sector involvement for the second package on Greece. Ireland spoke of this as a victory which would help in its efforts to regain market access. This is not how we see it and the market, which barely moved on this news, seems to agree.

By doing this, EU policy makers have blocked a neat exit strategy that could have shifted the burden of adjustment from the EU public sector to the private sector when the ESM was activated in 2013 so is a bad deal for EU tax payers.

Governance and Organization

Re-Define suggested that the ESM follow the standard IFI model by having a board of governors and country directors, albeit with a thin level of staffing since the ESM is a crisis mitigation institution that will be inactive most of the time. Furthermore we suggested that the ESM maintain close relations with the ECB, the European Commission and the IMF with the flexibility of engaging with other stakeholders.

On the issue of quotas, we suggested that member state GDPs, which we believe reflect a 'capacity to pay' be used instead of the ECB quotas used by the EFSF which impose a somewhat disproportionate burden on poorer states.

Member states have largely followed this model and have allowed for the ad-hoc participation of non Euro member states, the IMF and other bodies where necessary but have not accounted for an active involvement of the ESRB. This oversight may need to be corrected as member states realize how strong the sovereign-bank loop in the Euro area is.

The member states have agreed to a continuation of the ECB quotas used in the EFSF with a 12 year exemption granted to some member states based on lower GDP.

Decision making process and conditionality

Re-Define proposed that ideally a small percentage (say 5% of GDP) of funds should be automatically accessible to member states facing liquidity problems without any conditionality but had recognized that this may be difficult to achieve politically. We had also suggested that the conditionality burden imposed on member states borrowing from the ESM should be proportionate with the degree of conditionality tightened from minimal to substantial as the size and/or the duration of borrowing from the ESM increased.

Another recommendation from Re-Define had been that the decision making process envisaged should be simpler and more streamlined than has been the case for the multi-step somewhat convoluted and time consuming process used in the case of the EFSF. We had also suggested that the involvement of the IMF be optional rather than mandatory.

Re-Define had also suggested that the double supermajority (2/3 of states and 2/3 of voting power) be used for all contentious and important decisions with a simple majority for decisions that are merely operational. In particular this would help prevent any member state from wielding a de-facto veto and would give the ESM its own identity independent (to some extent) of its members as is the case for other IFIs.

The Euro member states have ignored any possibility of an automatic unconditional access to ESM funds which was to be expected given the tough politics behind the discussions on the ESM. However, they also seem to have ignored the possibility of proportionate conditionality or a flexible decision making structure having hardwired the somewhat clunky and time-consuming decision making process and the idea of 'strict conditionality' even for small amounts of ESM funds needed for the short term. Moreover the involvement of the IMF also seems to be hardwired into the ESM treaty though the language does allow for some flexibility in this regard.

This problematic decision making structure and the idea of tough conditionality will mean that the ESM would be less than effective as a crisis mitigation tool. Member states are likely to wait far too long, more than is optimal, because of the domestic political costs of agreeing to ESM conditionality as has been clearly illustrated in the Euro crisis so far. This will mean that the ESM would not be very useful for limiting contagion.

A big problem is that almost all important decisions of the ESM will be taken by mutual consent which refers in this case to unanimity with abstentions being ignored. In effect it gives each member state an effective veto and a repeat of the political circus that has characterized the present handling of the crisis is likely to recur and make the ESM far less effective than it would otherwise have been.

Toolkit of instruments

Re-Define suggested that the ESM use partial guarantees of new issuance of member state bonds as the instrument of choice with other instruments including 1) loans 2) lines of credit 3) primary market purchases and 4) buybacks in the secondary market being essential parts of the ESM arsenal. This would have allowed the ESM to exercise maximum leverage and would have ensured that member states in trouble continued to have market access even though such access would be on the basis of life support from the ESM.

The European Commission legal service rejected the idea of guarantees, something Re-Define legal experts have been surprised and confounded by. Presumably, giving other member states a loan is equally if not more against the sprit of the 'no bailout clause' as partially guaranteeing their bond issues is. Political posturing and an imperfect understanding of the economics of sovereign debt meant that the Euro area member states have also ruled out secondary market purchases and buybacks.

The ESM will thus primarily work on the basis of providing loans to member states in trouble with the possibility of primary market purchases under exceptional circumstances. The treaty keeps the possibility of using financial instruments alive but the decisions on this will need to be made on the basis of the hard to achieve 'mutual agreement'.