



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT **A**  
ECONOMIC AND SCIENTIFIC POLICY

BUILDING A COMPREHENSIVE CRISIS MANAGEMENT FRAMEWORK FOR THE EU AND EXTINGUISHING THE RAGING FIRE



Financial, Economic and Social Crisis

BUILDING A COMPREHENSIVE CRISIS  
MANAGEMENT FRAMEWORK  
FOR THE EU AND  
EXTINGUISHING THE RAGING FIRE

CRIS

EN

2011





**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES**  
**SPECIAL COMMITTEE ON THE FINANCIAL, ECONOMIC AND**  
**SOCIAL CRISIS**

# **BUILDING A COMPREHENSIVE CRISIS MANAGEMENT FRAMEWORK FOR THE EU AND EXTINGUISHING THE RAGING FIRE**

## **BRIEFING**

### **Abstract**

The on-going discussion on Crisis Management in the EU is incomplete and on particular issues misguided and ill-informed. This is true both of the longer term discussion on designing a Crisis Management Framework for the EU as well as the immediate and on-going efforts to put the fire out.

This Policy Paper has three parts: Part I maps out the structure of a complete Crisis Management framework for the EU. Part II offers detailed suggestions on improving the current Crisis Mitigation framework in the form of the European Financial Stabilization Mechanism. Part III sketches an optimal detailed design of what the permanent European Stabilization Mechanism should look like.

IP/A/ECON/NT/2010-21

January 2011

PE 451.492

EN

This document is a substantial update for the Special Committee on the Financial, Economic and Social Crisis of the paper entitled "Building a Crisis Management Framework for the EU" (contained in the compilation PE 440.292, "Euro Area Governance - Ideas for Crisis Management Reform" of September 2010) requested by the European Parliament's Committee on Economic and Monetary Affairs.

## **AUTHOR**

Sony KAPOOR, Managing Director, Re-Define ([www.re-define.org](http://www.re-define.org))

## **RESPONSIBLE ADMINISTRATOR**

Doris KOLASSA  
Policy Department Economic and Scientific Policies  
European Parliament  
B-1047 Brussels  
E-mail: [poldep-economy-science@europarl.europa.eu](mailto:poldep-economy-science@europarl.europa.eu)

## **LINGUISTIC VERSIONS**

Original: [EN]

## **ABOUT THE EDITOR**

To contact the Policy Department or to subscribe to its newsletter please write to:  
[poldep-economy-science@europarl.europa.eu](mailto:poldep-economy-science@europarl.europa.eu)

Manuscript completed in September 2010; update completed in January 2011.  
Brussels, © European Parliament, 2010 and 2011.

This document is available on the Internet at:  
<http://www.europarl.europa.eu/activities/committees/studies.do?language=EN>

## **DISCLAIMER**

The opinions expressed in this document are the sole responsibility of the author and do not necessarily represent the official position of the European Parliament.

Reproduction and translation for non-commercial purposes are authorized, provided the source is acknowledged and the publisher is given prior notice and sent a copy.

## CONTENTS

<b>EXECUTIVE SUMMARY .....</b>	<b>4</b>
<b>GENERAL BACKGROUND .....</b>	<b>6</b>
<b>1. Part I: Building a Complete Crisis Management Framework .....</b>	<b>6</b>
<b>1.1. Introduction .....</b>	<b>7</b>
<b>1.2. The design of an effective crisis framework.....</b>	<b>8</b>
<b>1.3. Crisis Prevention.....</b>	<b>9</b>
1.3.1. EU Measures.....	10
1.3.2. Policy discussion.....	11
1.3.3. Our Recommendations .....	12
<b>1.4. Crisis Mitigation (see Part II and Part III for detail) .....</b>	<b>13</b>
1.4.1. EU Measures.....	13
1.4.2. Policy discussion.....	14
1.4.3. Our Recommendations .....	16
<b>1.5. Crisis resolution.....</b>	<b>18</b>
1.5.1. EU Measures - Head in the sand .....	18
1.5.2. Other suggestions.....	18
1.5.3. Policy discussion.....	19
1.5.4. Our Recommendations .....	20
<b>1.6. Conclusion .....</b>	<b>23</b>
<b>2. Part II: Improving the European Financial Stability Facility (EFSF) 24</b>	<b>24</b>
<b>2.1. Abstract .....</b>	<b>24</b>
<b>2.2. Background .....</b>	<b>24</b>
<b>2.3. Does the EFSF have insufficient capacity? .....</b>	<b>25</b>
<b>2.4. Options for expanding EFSF capacity .....</b>	<b>26</b>
2.4.1. Changing the formula for the Guarantee .....	26
2.4.2. Going for AA not AAA rating .....	26
2.4.3. Introducing a Preferred Creditor Status for the EFSF.....	27
2.4.4. Providing Bond Guarantees not Loans.....	28
<b>2.5. Conclusion .....</b>	<b>28</b>
<b>3. Part III: Designing the European Stabilization Mechanism (ESM) ...29</b>	<b>29</b>
<b>3.1. Abstract .....</b>	<b>29</b>
<b>3.2. The Legal Basis and Form of the ESM.....</b>	<b>29</b>
<b>3.3. The Size .....</b>	<b>30</b>
<b>3.4. The Funding Model.....</b>	<b>30</b>
<b>3.5. Credit Rating and Funding Needs.....</b>	<b>31</b>
<b>3.6. Preferred Creditor Status.....</b>	<b>33</b>
<b>3.7. Governance and Organization.....</b>	<b>34</b>
<b>3.8. Decision Making Process.....</b>	<b>35</b>
<b>3.9. Toolkit of Instruments .....</b>	<b>36</b>
<b>3.10. Conclusion .....</b>	<b>37</b>
<b>REFERENCES.....</b>	<b>38</b>
<b>ANNEX TO PART III.: ESM flowchart .....</b>	<b>39</b>

## EXECUTIVE SUMMARY

A growing consensus of analysts and informed commentators have criticized both the EU's handling of the growing sovereign crisis in the Euro area as well as its proposed plans for future reform supposedly designed to prevent a recurrence of this crisis. There is an urgent need to change course.

This paper offers several new suggestions on how best to 1) institutionalize a successful and credible crisis management response in the EU in the short and long term 2) improve the existing European Financial Stability Facility 3) construct a permanent European Stabilization Mechanism

### Part I

We start by highlighting that too many of the proposed Economic Governance reforms seem to assume that irresponsible fiscal behaviour is the driver of much of the Euro crisis. This is simply not true. Germany and France often violated the Stability and Growth Pact (SGP) and had much higher levels of debt at the onset of the financial crisis than either Ireland or Spain, who had been the star pupils of the SGP. For both countries, it was problems in the private sector that eventually helped trigger the crisis so the reform package needs to be focussed on how to prevent this from happening again. Instead the package seems to focus disproportionately on Greece, which was a special case of a country hiding its true fiscal situation.

The other big shortcoming in the current package is that it focuses far too heavily on controlling outcomes of policy variables such as fiscal and macroeconomic balances but treats the complex processes behind them as a black box. The fact of the matter is that EU countries are free market economies not centrally controlled command economies. So government fiat does not run very far and if anything, is shrinking even more. There is a missing discussion on the need for policy space if MS are expected to be able to manage divergences smoothly in a monetary union.

On **crisis prevention**, simple measures such as 1) stress testing government budgets 2) increasing the use of countercyclical GDP linked bonds 3) increasing the average maturity of Euro area sovereign debt to 10 years and 4) using a strongly counter-cyclical prudential and regulatory policy to lean against nascent imbalances in the financial sector are sensible measures that will deliver real results.

On **crisis mitigation**, 1) expanding the size of the EFSF 2) the use of partial guarantees instead of loans 3) improving the ease of access to liquidity support for MS facing problems and 4) the setting up of a permanent liquidity support facility would all be useful for limiting contagion and increasing market confidence.

On **crisis resolution**, 1) the proposed reforms for introducing Collective Action Clauses into bond agreements are necessary but insufficient 2) the ideas for setting up a European Monetary Fund or a European Debt Mechanism are political non-starters and are far too inward looking and EU focused to be credible 3) there is a need to set up a predictable lean statutory mechanism in the form of an International Debt Restructuring Mechanism a) that will be seen as impartial by the private sector and foreign governments holding EU government bonds b) that will bring much needed predictability to the issue reducing scope for contagion c) that will appear not to single out EU bonds and d) that will be open for use by non EU countries in debt trouble. Support for such a discussion is at an all-time high.

In the shorter term, we believe that both Greece and Ireland will need to restructure their debts. The longer we wait, the larger the burden of adjustment will fall on the EU public sector rather than on foreign governments and the private sector.

Greek domestic law can be changed to facilitate such a restructuring through an exchange offer and the best option for Ireland in the short term is to revoke the guarantee it has provided to holder of senior bank debt and engineer a system-wide debt equity swap.

## **Part II**

At its current level, the EFSF does not appear to have a capacity that is large enough to limit market contagion, the main purpose it was set up for. EU policy makers exaggerated the total size of the EFSF that has a total lending capacity of only about EUR 250 billion as opposed to the EUR 440 billion headline size talked up by EU leaders. If Spain and Portugal also needed access to the EFSF, it would fall short by about EUR 150 billion. However, MS appetite for increasing their commitments to the EFSF is limited.

That is why, in Part II we present four options for increasing the effective size of the EFSF. 1) Dropping an insistence on an AAA rating for an AA rating will increase the effective size of the EFSF to EUR 400 billion 2) Switching to providing partial guarantees (against the first 40% of loss) for MS bond issues as we suggested in August 2010 and again in Part I of this paper, will increase the effective capacity of the EFSF to EUR 500 billion. This may run into some problems with Art 125 of the TFEU but needs to be examined as a matter of priority 3) Putting a preferred creditor status into the MoU that the EFSF signs when it provides aid to MS, can increase its effective capacity by about EUR 50 billion and finally 4) changing the formula for the provision of MS guarantees, which currently discriminates against poorer and smaller states, can increase the size to EUR 700 billion. Using some of these options (1 and 2 for instance) together can more than treble the effective firepower of the EFSF to more than EUR 800 billion.

## **Part III**

The European Stabilization Mechanism is being discussed as the permanent replacement for the EFSF so will be one of the most important tools in the crisis management apparatus of the EU. However, on-going policy discussions on the matter are not very well informed and seem to not have learnt lessons from the flaws in the design of the EFSF. This part of the paper lays out the state of the art and comprehensive analysis on the best options for the design of the ESM.

On the basis of our analysis we recommend that 1) the ESM should ideally take the form of an institution under community law with accountability to the European Parliament but that a treaty based structure may be a second best solution 2) should be adequately sized so as to meet the rollover needs of 1/3 of Euro area debt for a period of 2 years – EUR 600 – EUR 750 billion 3) should have EUR 7.5 – EUR 15 billion of paid in capital with about EUR 400 billion of MS guarantees or callable capital 4) should have a preferred creditor status that is preferably backed by the letter of law 5) should have a small secretariat that is able to draw upon relevant expertise in the EU on short notice 6) should ideally be able to provide at least part of its assistance automatically and unconditionally with the approval process and conditionality the longer the MS needs access and the greater the amount of assistance 7) should use the provision of partial guarantees for MS bond issuance as the instrument of choice for providing assistance.

## GENERAL BACKGROUND

There are two parallel discussions at the top of the current European Agenda. The first is to do with enacting reforms to prevent a repeat of the financial and sovereign crisis that the EU still has to recover from. The second is the more immediate concern of how best to draw a line under the crisis.

In this paper, we address both parts of these agenda, but only in part. On the longer term agenda of preventing a repeat of the crisis, this paper deals only with the problems associated with the sovereign debt crisis, not the financial sector crisis though the two are intimately linked. Our suggestions on financial system reform and crisis management can be found in other publications from Re-Define.

On the more immediate agenda of drawing a line under the on-going crisis, this paper addresses only the reform of the European Financial Stability Facility (EFSF) and does not offer immediate suggestions on how best to 1) restructure Greek sovereign debt and 2) restructure Irish banks' senior bonds both of which we believe are necessary to exit the current crisis. These are addressed elsewhere<sup>1</sup>.

Since the EU policy makers have announced that the permanent European Stabilization Mechanism (ESM) will be modelled on the existing EFSF, we have also put forward a detailed proposal for the best options for such a mechanism in Part III of the paper. This discussion is happening in parallel to the reform of the EFSF with concrete outcomes expected by March 2011.

### **1. PART I: BUILDING A COMPLETE CRISIS MANAGEMENT FRAMEWORK**

Despite the fact that the discussion of the euro area crisis has focused primarily on issues in the sovereign debt market, it is instructive to remember at the outset that this crisis is not primarily a sovereign crisis but one that originated in the private financial sector. As often happens in credit crises, private sector debt is taken on to public balance sheets which makes them fragile and can, as in this case, result in serious dislocations of the sovereign debt market.

Though Greece's problems have (at least partly) had to do with misreporting statistics and a genuinely unsustainable public balance sheet, the problems faced by countries such as Ireland and Spain originated primarily in excessive risk taking and unsustainable levels of activity in the private financial and real estate markets. In fact, Ireland and Spain were the star pupils of the Stability and Growth Pact, hitherto the euro area's main bulwark against fiscal problems while bigger states such as Germany and France violated the pact at least as often as they respected its provisions. In the decade prior to the crisis, Ireland halved its debt stock to 23% of GDP and Spain reduced its debt burden from 60% to 40%. It is good to remember that Irish sovereign debt problems are a direct result of the Irish government having guaranteed all senior bank debt.

That is why any discussion on the management of the euro area's fiscal problems cannot be had in isolation from a discussion of crisis management in the financial sector. In fact, as this paper highlights, there are several lessons that can be usefully applied to the management of sovereign debt crisis from measures that have been suggested and used in the management of crises in the financial sector.

---

<sup>1</sup> See S. Kapoor: How to Exit the Euro Crisis? Re-Define Policy Maker Brief, 2011.



What makes these lessons particularly useful is that discussions on the management of banking crises are more advanced than the discussions on managing sovereign debt problems. We apply some of these concepts in making suggestions on how sovereign debt problems can be prevented.

Thus far, the policy discussions on handling problems with sovereign debt

- 1) have ignored the role of problems in the financial sector;
- 2) have assumed unrealistic levels of government control of economic outcomes;
- 3) have focussed primarily on crisis mitigation rather than crisis resolution;
- 4) have ignored the limits and idiosyncrasies of policy making in modern democracies;
- 5) have ignored the difficulties in bringing about structural changes and have forgotten that;
- 6) have not recognised that in order to try and achieve multiple policy objectives, governments need to have a larger portfolio of policy instruments.

## 1.1. Introduction

In order to influence policy making on economic governance in the EU, it is important to highlight the assumptions and parameters that are implicit in our approach to improving the crisis management framework in the euro area. At minimum, any such framework must successfully address 1) the problems faced by Greece on the one hand, and 2) Spain and Ireland on the other. It must also address 3) the underlying all-critical question of how best to manage continuing divergences within the euro area in a way that is not destabilizing. Our aim in this contribution is to devise a complete crisis management framework that would tackle these three distinct aspects of the ongoing crisis.

In suggesting this framework, we make the following **assumptions** from which the conclusions and policy proposals put forward in this paper naturally follow:

- No new institution should be established unless really needed – the EU institutional landscape is already too fragmented.
- Political appetite from Member States for ‘an ever closer fiscal union’ is likely to remain particularly low in the near future.
- Substantial changes to the Treaty, at least in the short term, are not really possible.
- Given a choice we have a preference for a pre-planned crisis management system that minimises the role of ad hoc midnight emergency cabinets.
- Fiscal transfers to other Member States are against the spirit, if not the letter of the Treaty and should be avoided as far as possible especially since they can backfire and trigger a political backlash. While an ‘ever closer fiscal union’ may be a good idea, the EU does not seem ready for it yet. The worst scenario would be a move towards a ‘shadow fiscal union’ where transfers across Member States are hidden from public view.
- While prevention is better than cure, it is never foolproof so we need to always be prepared for contingencies.

Next, we list some **observations** which form the basis for our analysis:

- In today’s increasingly complex and interconnected world, there are serious limits to the degree of influence that government policies can have on economic decision making.
- Such limits are especially binding in an open free market economy where the room that governments have for manoeuvre is seriously limited.

- Room for national level policy action in the euro area is especially constricted because of loss of monetary policy autonomy, the confines (at least on paper) of the Stability and Growth Pact, highly interconnected financial markets and an increasingly harmonized regulatory environment.

Economic outcomes are partly deterministic and partly stochastic so even with the best of intentions there are limits to what governments can do and control in their economies. Our objectives, assumptions and observations lead us to conclude that the European Economic Governance **discussions need to focus on four things** in particular.

1. Better economic policy co-ordination to the extent this is possible under the terms of the current treaty and prevailing political climate. Co-ordination, it is to be remembered, is not the same as uniformity.
2. A recognition that even with the best of intentions and good co-ordination, euro area economies are structurally, culturally and politically different enough so that substantial economic divergences are likely to continue into the near future. Since these cannot be wished away, policy makers need to focus on devising instruments and approaches that can help mitigate potential negative impacts, such as large imbalances, that might result from these divergences.
3. A recognition that even with better co-ordination and new policy instruments in place, the threat of future crises would remain ever present so any sensible policy making would need to put in place an effective crisis management system for the euro area.
4. Effective crisis management frameworks must be put in place for both sovereigns as well as the financial (banking) sector. Sovereigns provide the final backstop for the banking sector and the banking sector in turn is a significant provider of finance to sovereigns. The high degree of interdependence between the financial sector and sovereigns has become clear in this crisis. Banking crises often lead to sovereign debt problems and sovereign debt problems will almost inevitably increase the likelihood of a banking collapse.

Now that we have stated our assumptions and methodology upfront, the rest of this paper will address the design of an effective crisis management framework for sovereigns in the euro area. The underlying assumption here is that a parallel crisis management framework for the financial sector is already being put in place.<sup>2</sup>

## 1.2. The design of an effective crisis framework

Crisis management is firstly and foremost about minimising the likelihood of occurrence by putting in place effective ex ante risk reducing policies – **Crisis prevention**. No matter how good such policies look on paper, economic externalities, and endogenous developments in financial markets or stochastic factors can dislocate even the best plans and trigger potentially destabilizing disturbances in the financial markets. These often take the form of liquidity black holes and/or asset prices collapses and/or a collapse in confidence. The challenge at this stage is to contain the crisis, limit damage, stop widespread contagion and restore confidence – **Crisis mitigation**. Even with the best of efforts to contain a crisis, sometimes it will deepen and spread. Under such a scenario, mitigation gives way to rescue and making a fresh start – **Crisis resolution**.

In fire-fighting terms, prevention comes from having a strong fire code, responsible behaviour and taking appropriate precautions. The distinction between crisis mitigation and resolution is somewhat arbitrary but nonetheless critical. Crisis mitigation is about putting out an incipient fire and stopping it from spreading. It will involve the use of smoke alarms, hand-held fire extinguishers, fire blankets and fire doors.

---

<sup>2</sup> Kapoor, Sony: The Financial Crisis, Causes & Cures, Re-Define Book, 2010.

Mitigating a crisis or a fire successfully often entails little cost or damage and going back to the 'normal state of affairs' is usually easy.

If the crisis or fire is too large or the mitigation tools are inadequate, the problems deepen and spread and cause widespread damage. This is where the big boys, the fire brigade or in the case of financial markets, recapitalizations or bankruptcy are needed to help limit damage and make a fresh start. The degree of collateral damage and the possibility of a healthy fresh start depend on the quality of crisis resolution and rescue measures, or in the case of fire, on the quality and response time of fire brigades and the existence of appropriate insurance policies.

**Crisis prevention** depends on 1) responsible fiscal and monetary policies, 2) sound regulation, 3) a countercyclical approach to policy making, 4) moderate to low levels of public and private debt, 5) minimising imbalances and 6) having sufficient room for policy manoeuvre to lean against unfavourable developments. Better co-ordination and surveillance can help too, particularly in the context of the euro area. Prudence and policy space are critical here.

**Crisis mitigation** has a lot to do with 1) moving quickly to restore confidence in the financial markets, 2) provision of temporary liquidity and balance of payment support and 3) ring fencing problems so as to minimise contagion. Speed of intervention, minimising conditionality and a credible scale of intervention are critical at this stage. Having a much clearer view of the endgame, in case mitigation fails, can also help calm nerves and restore some semblance of order in the market.

**Crisis resolution** often entails substantial costs and involves structural changes, particularly for private sector entities. 1) ex-ante contingency plans, 2) formalized speedy resolution frameworks and 3) the possibility of orderly restructuring are all essential elements of an effective crisis resolution toolkit. A fair burden sharing procedure, predictability and the possibility of redemption are critical at this stage.

Thus, an effective crisis management framework for the EU will focus on putting crisis prevention, crisis mitigation and crisis resolution tools in place for both the financial sector and sovereigns. In the next section, we discuss some of the main features that such a framework will entail, list what new policy measures have been put on the table and make suggestions on how to improve and strengthen the nascent crisis management apparatus that will need to be a central part of any reform of EU economic governance.

### 1.3. Crisis Prevention

A crisis prevention framework will focus on stopping the build up of excessive risks in the financial system as well as on limiting fiscal and macroeconomic imbalances. This is best achieved through a combination of: 1) prudent principles and targets 2) better euro area level co-ordination 3) that are owned by Member States and 4) the availability and use of appropriate policy tools 5) in a countercyclical manner so as to minimise the build-up of risks. Importantly, such an approach would necessarily include private and public financial activity and have a macro and micro dimension.

We have at our disposal a set of five major policy categories that, at least in theory, can be used to manage economies in a way that best helps prevent the occurrence of a crisis. These are: 1) monetary policy 2) fiscal policy 3) regulatory policy 4) policies on competitiveness and 5) structural policies, listed in a rough order of short term flexibility.

However, not all of these policies are available to euro area governments. Even when policy space was available, it was not always used appropriately.

In particular, euro area governments face some critical challenges which are that:

- Monetary policy is conducted by the ECB and national governments have no room for adjusting this to better fit local economic conditions.
- The Stability and Growth Pact (SGP) has limited room for manoeuvre of fiscal policy (if not very effectively).
- Regulatory policy for the financial sector was lax and allowed far too much risks to build up in euro area financial systems.
- Competitiveness has been ignored because the current account imbalances that allowed divergences in competitiveness to be sustained were ignored both by the SGP and by the financial regulators, and
- The political economy of structural policies is such that it is very hard to change them.

This meant that the divergent growth and inflation rates in the euro area led to sustained negative real interest rates in countries such as Ireland, Spain and Greece which brought about asset bubbles, especially in Spain and Ireland. These bubbles were financed, in part, by financial institutions in low inflation slow growth economies such as France and Germany. When the financial crisis hit, both sets of countries were vulnerable and as public balance sheets absorbed financial system risk, markets reassessed the credit worthiness of countries within the euro area.

The fiscal balances that the SGP observed missed the build-up of these risks altogether and by the time Spain saw its fiscal account turn from being in surplus to having a 10% deficit, it was too late for crisis prevention measures to have any effect and the EU was forced to turn to crisis mitigation. This has been one of the drivers of efforts at the EU level to improve the crisis prevention framework in the euro area. Several policy measures have been suggested, some by EU institutions, others by academics and think tanks. We discuss these briefly and make our own suggestions for improvements.

### 1.3.1. EU Measures

The main measures already agreed (at least in principle) under to reduce fiscal are:

- Improving the quality, scope and timeliness of economic information in order to facilitate better co-ordination at the EU level and the introduction of the European Semester;
- Strengthening the sanctions under the SGP and focusing not just on the values of the deficit and debt stock parameters but also their rate of change and the scope for early intervention before limits are breached;
- Strengthening the EU macroeconomic framework which is currently very weak;
- A renewed call to focus on policies for structural reform and measures to restore competitiveness in euro area countries that are lagging behind.

Other suggestions include

- 1) Introducing National Fiscal Councils;
- 2) Taxing debt levels in excess of 60% (directly or indirectly);
- 3) Stronger sanctions in terms of withdrawing access to the ECB and to the EFSF in case of excessive debt levels;

- 4) SGP implementation through an independent body at the EC level;
- 5) The issuance of Eurobonds in various forms;
- 6) The introduction of an automatic debt brake into national constitutions in line with what Germany has done.

### 1.3.2. Policy discussion

The biggest indictment of the SGP in its current form was that Spain and Ireland, which did not violate the SGP and ran surpluses, were amongst the countries most vulnerable to the sovereign debt crisis. The SGP, with its exclusive focus on fiscal balances, completely ignored private sector imbalances and the related current account imbalances. So extending the mandate of the SGP to monitor risk building and excessive private sector, financial sector and current account imbalances is the sensible thing to do.

However, while fiscal policy might, at least for the most part, be under government control, other economic outcomes are the collective results of millions of individual decisions by economic actors so governments can at best have only a limited influence on them. The EU and its constituent states are not command-economies, so there are serious limits to what even willing governments are able to accomplish in the name of co-ordination or reduction of imbalances.

So, while the European semester, peer review of budgets and enhanced efforts at co-ordination are welcome steps there should be an explicit recognition at the outset that these steps will not eliminate imbalances and divergences but can only mitigate them somewhat.

Since most of the domestically originating observed financial instability in the EU can be traced back to intra-euro area divergences, there is an urgent need to also devise additional policy instruments that give governments more policy space to 1) try and mitigate divergences and 2) make sure that any divergences are managed to minimise imbalances and the externalities and financial instabilities associated with them.

Negative real interest rates were the major drivers of housing bubbles in countries such as Spain and Ireland and one of the causes of over-indebtedness in Greece. In the absence of any monetary policy space to manage significant real interest rate divergences, the **main options** available to euro area countries are:

- Using fiscal policy as the main adjustment tool. However, in order to compensate for the negative real interest rates observed in a country such as Spain, the government would have needed to run a fiscal surplus of the order of 8%-10% of GDP which, any political economist would agree, is next to impossible.
- Using structural policies and wage adjustments as the main policy tool. The problem here is that governments have only limited control on wage policies, and that structural reforms of this kind are extremely difficult. Wage restraint in a time of fast economic growth is almost unheard of. While ideally there should be more structural reforms of the kind the EU has been calling for over decades, we should not delude ourselves with the likelihood and extent of any such reforms that might happen.

In other large economic federations such as the United States, fiscal transfers and labour mobility are far higher and offer stronger adjustment mechanisms to mitigate any problems caused by divergences but neither of these is an option for the euro area in the medium term.

The problems with other suggested proposals such as National Fiscal Councils, the European Monetary Fund, the debt brake, the Blue Bond proposal etc are that they all focus on the symptoms (fiscal accounts) rather than the fundamental causes, such as: limits to government fiat, stochastic economic shocks and the lack of sufficient policy space to run a countercyclical policy.

The implicit assumption in many of these proposals is that it was a lack of willingness on the parts of euro area governments, rather than a lack of ability or policy options, that led us into this crisis. This assumption is seriously flawed.

### 1.3.3. Our Recommendations

In order to further strengthen the crisis prevention framework in the euro area, we propose:

- **Introducing differentiated reserve requirements run by national central banks:** Because the spread of real interest rates is a continuing source of divergences and imbalances, allowing national central banks to require domestic banking operations to hold different amounts of unremunerated (zero interest) reserves against liabilities can help adjust real interest rates so they are more suitable for the national economic conditions. This will help reduce the build up of excessive risks and imbalances. Currently the ECB levies uniform reserve requirements that it pays interest on. This will need to change. However, this may be legally and operationally complicated. In this case a similar end-result can be achieved by using asset based reserves (see next bullet point).
- **Using a countercyclical prudential and regulatory policy :** Member States have at their disposal a number of instruments such as asset based reserve requirements, loan to value ratios, financial transaction taxes, loan loss reserve targets, capital buffers and bank levies that can be used counter cyclically in conjunction with or as a substitute for the liability based reserves we have suggested above.
- **Using GDP Linked Bonds:** Member states could start issuing GDP linked bonds where the interest is linked to the GDP growth rate so debt service payments increase in boom times when a country can most afford them and fall in a slowdown giving the country some breathing space and thus acting to stop a temporary economic dip from turning into a recession. These bonds hardwire an automatic counter-cyclical fiscal policy which is stabilizing for the economy. Market surveys indicate that there is a growing appetite for such bonds.
- **Stress testing budgets and contingency budget plans:** Member states should be obliged to stress test their budgets against a number of scenarios that are decided by the European Commission, publish the results and take them into account to introduce more counter cyclicity in fiscal policy. In addition to this, Member States should be made to publish contingency plans for fiscal policy that detail what a Member States would do in the event of facing fiscal problems that would need to include 1) where it would obtain temporary liquidity from – how much and at what rate 2) which taxes it would raise 3) which expenditures would it cut 4) how it would deal with a solvency problem.
- **Lengthen the maturity profile of country debt:** The Commission should introduce minimum targets on the average maturity profile of a country's debt since, as we saw in the present crisis, Member States such as the UK that had a longer maturity profile (12 years) on their debt found it easier to tide over temporary dislocations in sovereign debt markets compared to Member States with shorter maturity profiles (most Euro area Member States had an average debt maturity profile of 5-7 years) who faced the prospect of rolling over large fractions of their debt under stressed market conditions.

## 1.4. Crisis Mitigation (see Part II and Part III for detail)

Crisis mitigation is all about nipping incipient problems in the financial sector and the sovereign debt markets in the bud. Crisis mitigation comes into play at the first hint of financial market dislocation.

Since market expectations feed back into prices, which affect fundamentals as well as the future evolution of fundamentals, these expectations can become self-fulfilling. Contagion can come about as low confidence feeds back into expectations and afflicts other parts of the market portfolio. So a circuit breaker mechanism that can halt this feedback cycle should be at the core of crisis mitigation.

Crisis mitigation comprises four main sets of policies: 1) provision of liquidity 2) measures to restore confidence 3) limiting contagion and 4) having a predictable next stage in case mitigation does not work.

In fact, the main focus of new policies and measures in the euro area has been on crisis mitigation, where a number of new measures have already been introduced.

### 1.4.1. EU Measures

BOX: EU Crisis Mitigation Facilities						
Facility Name	Legal Entity	Institution	Form of Support	Amount	Scope	Terms
ESFM	EC	EC	Loan	EUR 60 billion	All MS	Non Concessional
EFSF	Private	Eurofin governance of Private Luxembourg Entity with MS shareholders	Loan	EUR 440 billion Effective size EUR 250 billion	Euro MS	Non Concessional. Penalty to cost of funds for EFSF but below Market
EboP	EC	EC	Loan or Guarantee	EUR 60 billion	Non Euro MS	Non Concessional
Macro	EC	EC			Non MS	
ECB Bond Purchase	ECB	ECB	Market Support	EUR 80 billion?	Euro MS	Market
Greek Rescue	IMF/ MS Bilateral MoU	IMF/MS	Loan	EUR 110 billion	Greece	Mixed

For sovereigns, measures put in place include 1) the rescue package for Greece 2) the EFSM 3) the EFSF 4) ECB measures (see Box below).

#### **BOX: Crisis Mitigation Measures introduced by the ECB**

- Exempting Greek debt from minimum credit rating requirements for the purpose of collateral. Lowering Collateral Standards for Sovereign Bonds
- Purchasing Greek, Irish, Portuguese and Spanish debt in the secondary market in order to help reduce some of the excessive margins the markets were charging these countries on their debt rollover.
- Supporting Greek, Irish, Portuguese and Spanish banks as well as weaker banks from other Member States with unlimited liquidity provision close to EUR 800 billion

*Source: ECB Website and Financial Times*

#### **1.4.2. Policy discussion**

The ECBs contribution to crisis mitigation measures has been large and substantial, especially for the banking sector. There has been a renewed and growing interest in the idea of introducing Eurobonds. Much of the debate is somewhat misinformed and there is a perception that Eurobonds are 'new'. However Eurobonds of one kind or another have been in existence for several years now. The EIB borrowing in financial markets is a Eurobond as is borrowing by the EC for its Balance of Payment facility. The EFSF's bonds, that are about to be issued for finance the Irish rescue package will also be Eurobonds, albeit of a different kinds. The bonds issued to support Ireland under the EFSM by the European Commission, are also Eurobonds again of yet another kind.

There are several important aspects which need to be discussed for a true and accurate picture of what Eurobonds can and cannot do and whether they are indeed the panacea that several proponents sometimes make them out to be. For this it is important to remember that there are several different parameters that go into the design of such a bond so two Eurobonds with different design parameters would look very different from each other. The main parameters are: 1) Issuing entity 2) Purpose of issue 3) whether they are issued in lieu of or in addition to national bonds 4) guarantee mechanism.

Eurobonds can prove to be useful both for crisis prevention and crisis resolution and may also have a role in crisis mitigation but it is critical to remember that they are not a panacea. A more detailed appraisal of Eurobonds is contained in this compilation of papers so we do not expand on this discussion.

#### **BOX: SWOT ANALYSIS OF THE EFSF (AND EFSM)**

##### **Strengths**

- Substantial as long as the problem is limited to the periphery
- Involving all other members so increasing peace time incentives to monitor each other and limit moral hazard
- No upfront funding needed



### Weaknesses

- Intended to only be primarily liquidity management tool
- Tackling a liquidity problem with a liquidity management tool solves it but tackling a solvency problem with this is simply delaying the inevitable. The longer we wait to restructure Irish and Greek debts, the greater the transfer of the burden of adjustment from the private sector and international governments to euro area governments which would be politically poisonous
- The one month time period for action from request to issue can be too long in the midst of a crisis.
- The two stage process of the EFSF/EFSM issuing bonds and then giving the Member States government a loan is needlessly complicated and expensive
- These are temporary facilities so a permanent ESM is needed as soon as possible
- Too small to have any real impact especially if any of the larger Member States gets into trouble. They can just about mitigate rollover risk for say a month, but then again, it might be much more sensible to issue guarantees instead of bonds. Despite the headline EUR 440 billion size of the EFSF, it only has a capacity for providing about EUR 250 billion in funds.
- The total size of funds available under the EFSM, EFSF and IMF packages falls short by about EUR 100 billion – EUR 150 billion if Portugal and Spain also need EFSF support
- The cost of funds provided (around 6%) is too high. A 6% interest burden would be very difficult for a countries such as Greece and Ireland to bear given their fragile fiscal situation
- The Member States have decided against going for a preferred creditor status which exposes them to much higher levels of credit risk
- Because of the current structure (where the Member States getting EFSF support no longer stands behind it) the size of the fund would diminish exactly when the demand for it would grow

### Opportunities

- Could be the precursor of an EU wide or at least euro area wide fiscal instrument
- Can be made permanent to provide crisis mitigating liquidity support. This is what the on-going ESM discussion (Part III of this paper) is about
- Could force the discussions on a more integrated EU crisis management framework
- Might grow with the size of the EU budget (the EUR 60 billion EFSM supported by the Commission budget), a longer-term objective of ever closer union.
- The effective size of the EFSF could be increased to EUR 400 billion if EU policy makers were ready to accept a AA rating instead of a AAA rating (See Part II)
- The effective size can be increased to EUR 750 billion if the EFSF provided partial guarantees (against the first 50% of loss on new bonds issues by troubled Member States) instead of loans as it currently does (See Part II)

### Threats

- At the high interest rates at which funds are being offered, this could exacerbate the solvency problem and be self defeating
- If there are losses inflicted on other Member States, this could potentially be in violation of the spirit, if not the letter of the Treaty
- Such losses may also harden political opposition to 'ever closer union' and may exacerbate Member States tensions
- It is a network of bilateral loan agreements that make it possible for Member States to pull out
- The fund does not have ultimate seniority over other loans
- Issuance of bonds by the EFSF might have a crowding out effect on Member States bonds

### 1.4.3. Our Recommendations

While the EFSM/EFSF design is far from perfect, it can provide the basis for a good crisis mitigation tool for the euro area, particularly if policy suggestions for improving the set up are taken on board. Some of these are:

- **A formalization of liquidity provision for sovereigns:** Because the IMF, the traditional provider of liquidity support for crisis mitigation is too small for most large euro area economies, the EU needs an additional vehicle to supplement the IMF's funds. We recommend that the EFSF should be made permanent to serve this purpose and its present minimum institutional structure is ideal for providing liquidity to euro area members on the back of an IMF program. The EFSM/EFSF should explicitly be only a liquidity support vehicle with clear safeguards against credit losses. We had made this suggestion in August 2010 and this has since been taken on board by Policy Makers who are discussing the set-up of a permanent ESM.
- **Preferred creditor status for the EFSF funding lines:** These safeguards can take the form of a preferred creditor status equivalent to the formalized US debtor in possession financing for working capital under the Chapter 11 bankruptcy framework or the less formal preferred creditor status conferred on multilaterals such as the IMF and the World Bank. EU Member States should formally institute changes into their domestic law so the EFSF or EFSM are treated as de jure preferred creditor at par with the similar status that multilateral organizations such as the IMF enjoy.
- **Reduce the rate of interest charged:** Since by definition the EFSF will provide support to Member States in trouble, the penalty interest rate charge seems misplaced. Though a similar penalty is sometimes levied on the provision of liquidity support by central banks to the private sector, the situation with sovereign states is different enough not to justify a similar treatment. The IMF typically (as in the case of Greece) provides temporary support at a lower cost of funds. So the EFSF should provide funds at cost or at the rate at which the IMF is lending to the Member States in question. A 5% interest rate in the case of Greece would simply worsen its finances.
- **The EFSM/EFSF should provide 'working capital' for crisis resolution:** As will be discussed in the next section, crisis mitigation measures are not always enough. This means that Member States would sometimes need to restructure their debts. They will temporarily lose market access during this process but will still need access to funds. This is where a liquidity support facility such as the EFSF can continue to be useful by providing such funds but only under a clear legal guarantee for being first in line to get repaid should the crisis resolution process go awry.
- **The EFSM/EFSF should provide guarantees not loans (Also see Part II and Part III):** We strongly believe that there are several advantages to the EFSM/EFSF providing bond guarantees rather than loans. A guaranteed bond issue program should provide enough time to deal with both liquidity and solvency problems that any Member States faced. It also avoids duplication and excessive transaction costs that are associated with the process of first issuing EFSF bonds and then making loans to Member States.

The second big advantage of a guarantee mechanism is that it is much quicker to use so in the event of a liquidity emergency, guarantees can be issued for 'new bond issuance' more or less instantaneously rather than having to wait a month which the current suggested framework of EFSF issuance/Member States loans would imply.

The third big advantage of a guarantee scheme is that it can help leverage a limited amount of funds. Looking at the model that MBIA and AMBAC, two municipal bond insurers in the US used before the financial crisis hit, it is clear that a smallish commitment from Member States to the EFSF can support a larger bond issuance program at least double in size if partial guarantees are used.

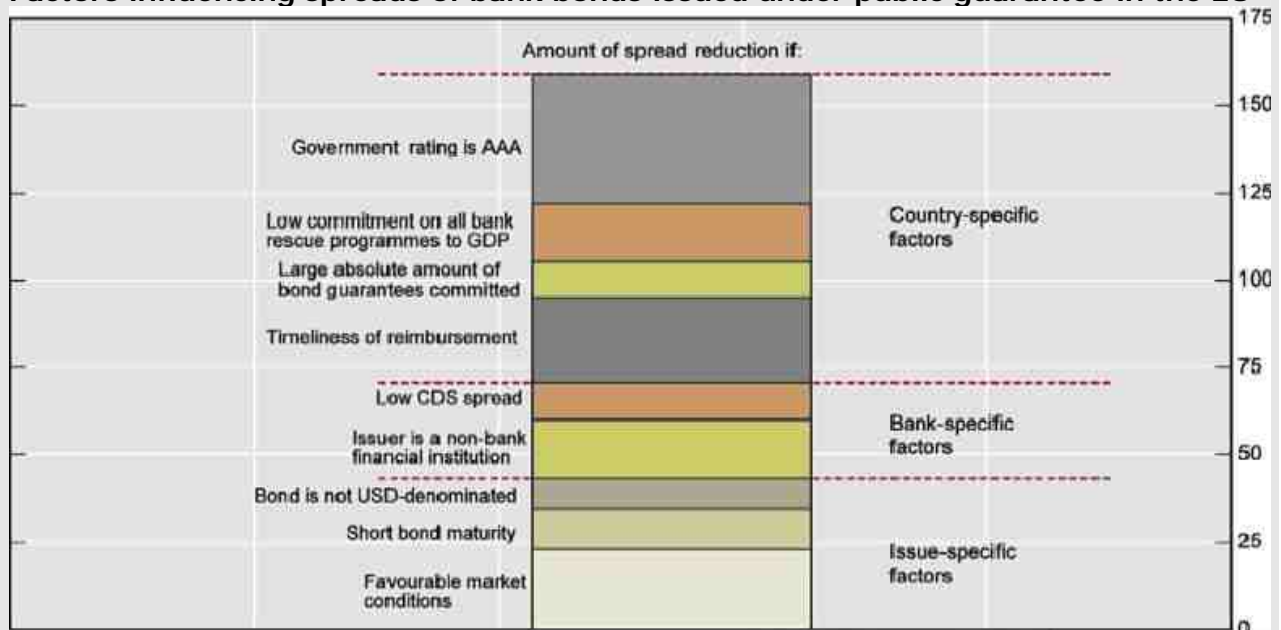
The use of guarantees over loans would also mean that the debt statistics of euro area Member States as a whole would look more favourable on paper and it is likely that the overall interest costs to euro area Member States would be lower.

There are several big advantages to using guarantees that are discussed in Part III. A potential problem with the use of guarantees by the EFSF is that these could violate Art 125 of the TFEU though the addition of the proposed amendment to Art 136 of the TFEU should address this problem.

**BOX: THE EU BOND GUARANTEE PROGRAM FOR BANKS**

More than EUR 600 billion of bonds were successfully issued by EU banks under Member State guarantees, and these were very effective in stemming the crisis. This concept should be translated to sovereign bonds.

**Factors influencing spreads of bank bonds issued under public guarantee in the EU**



Source: "Government guarantees on bank funding: Should we extend them into 2010 despite improved bank profitability and the schemes' distortionary effects?" Vox EU column by Aviram Levy and Fabio Panetta, 2009

As the previous graph shows, the most important determinant of the cost of issuing guaranteed bonds is the strength of the guarantee (the country specific factors in the graph) with the nature of the issuing entity and liquidity of the bond issue being far less important.

EU banks have issued more than EUR 600 billion of government guaranteed bonds since the collapse of Lehman brothers and this has been a crucial crisis mitigation and liquidity provision instrument for banks which otherwise would have potentially collapsed after the crisis reduced possibilities for reasonably priced funding.

The cost of guarantees at 0.5% for bonds can be used as a benchmark for states. UK, German and French banks all issued more than EUR 100 billion of guaranteed bonds each. At one point, in the first quarter of 2009, as much as 30% of the funding needs of European banks were met through the issuance of guaranteed bonds.

## 1.5. Crisis resolution

Crisis resolution measures are mostly about restructuring debt and defining the burden of losses, which in the case of a firm involve 1) winding up or 2) declaring bankruptcy or receiving capital injections. For sovereign states these involve the restructuring of debt liabilities, with or without a formal default.

There has been little progress on instituting crisis resolution measures in the EU so far. Work is in progress on making provisions for a predictable and fast mechanism for resolving financial institutions but crisis resolution work for sovereign debt problems is not formally on the agenda of policy makers.

### 1.5.1. EU Measures - Head in the sand

EU leaders seem to have decided to put their heads in the sand and hope that the Euro sovereign debt storm is temporary and will blow away. While a number of steps, as discussed in the previous section, have been taken to present liquidity support to Greece, none of them account for the possibility that the Greek sovereign debt situation is simply unsustainable. With debt levels expected to stabilize around 150% GDP, a sharp downward revision to the GDP, increasing interest rates payable and the bulk of interest payments being made to Greek bondholders outside the country, it is unlikely that Greece will be able to repay its debts on existing terms.

The markets are also factoring in the possibility that Ireland and even Portugal might need debt restructuring.

Even if one suspends disbelief for a minute and assumes that Greece/Ireland will be able to service its debts, it remains very difficult to justify why the burden should be shouldered exclusively by Greek/Irish public finances and why at least some of the burden should not fall on the private sector owners of Greek sovereign bonds and the senior bondholders of Irish bank debt. Bleeding a patient to cure him did not work in the middle ages. There is no reason why it would work now.

(There are some who say that this is the only way Greece and Ireland will make the reforms that are strictly necessary for its long term vitality. That might be so. But the collateral damage being inflicted on several poorer segments of the Greek and Irish society is hard to justify. Surely there is a less round-about way of bringing this about.)

### 1.5.2. Other suggestions

Other commentators have made suggestions for putting in place debt resolution measures for the euro area in general and Greece in particular. These have in most cases involved suggestions for setting up a European Monetary Fund or a European Debt Mechanism. There have also been additional suggestions for putting in place collective action clauses which is the main tool being discussed by EU policy makers at this time.

However, for reasons elaborated in the next section, we do not find these suggestions to be wholly convincing though there are important aspects that can prove useful in the design of a more comprehensive crisis resolution mechanism.

### 1.5.3. Policy discussion

The EU's actions on insisting that Greece, Ireland and Portugal do not have a solvency problem are understandable in the context that policy makers did not want to spook the markets into a panic. However, these are ultimately self defeating and while the case for ignoring solvency issues might have been stronger in May, the sooner these are acknowledged and dealt with the better it is for all actors involved – the financial markets, Greece and the other euro area Member States. Similar mistakes have been made in the case of Ireland.

By refusing to acknowledge the depth of Greece's and Ireland's problems upfront, the EU has boxed itself into a serious corner. The longer we wait to recognize that Greece and Ireland have a solvency, not just a liquidity problem, the bigger the burden of any eventual adjustment will need to be borne by the public sector in the EU as an ever increasing proportion of outstanding Greek and Irish debt will be directly or indirectly owed to fellow Member States. Already the ECB reportedly holds as much as 20% of outstanding Greek and Irish bonds and if we wait till 2013, as much as 50% of all outstanding debt from these countries will be owed to EU public sector entities.

Such fiscal burden sharing would not only be politically poisonous but will also be against the spirit, if not the letter of the Treaty.

That is why Greek and Irish debt needs to be restructured, and done as quickly as possible, to enable the bulk of the burden to be shared between the Greek public sector on the one hand and the largely private sector holders of Greek and Irish debt inside and outside the EU on the other. This is primarily an issue of burden sharing between these two constituencies and should have been explicitly recognized to be so.

An increasing number of commentators have been calling for the restructuring of Greek debts. There have been proposals to set up a European Monetary Fund (EMF) or a European Debt Mechanism (EDM), driven primarily by recognition to put in place a framework that would allow for sovereign bankruptcy.

However, there are already far too many institutions in the EU and the economic governance structure is already far too fragmented, so the establishment of yet another institution should be avoided to the extent possible.

Moreover, foreign governments hold more than \$1 trillion of euro area government debt and would be highly uncomfortable with any EU based institution being able to assign haircuts on holdings of euro area bonds due to potential for conflict of interest. That is why any institutional structure that deals with euro area state insolvency or debt restructuring has to be international and independent from the EU.

The IMF's Sovereign Debt Restructuring Mechanism failed to win widespread support partly because it was seen to be too close to the public sector by private bond holders, and in addition it was seen as potentially conflicted since the IMF too would have exposure to sovereigns whose debts it would help restructure. The right lesson from that is again that the EU cannot depend on an EU institution for restructuring as this would not be seen to be fair by the private sector, which is expected to bear a large part of the burden of any euro area government debt restructuring.

Because both foreign governments and the private sector will bear costs of the haircuts, it is essential to have an institution that would be acceptable to them and which would be seen to be independent of excessive government influence in general and the EU influence in particular. That is why we are strongly in favour of an international mechanism for debt resolution not a European one.

Adding collective action clauses to all future bond issues in Europe has also been proposed as a measure that can help a country restructure its debts when it gets into trouble. By itself this is a good idea, but 1) it involves a long transition period and 2) restructuring even with collective action clauses involves a long and tedious negotiation process with each outstanding bond issue needing to be separately negotiated. Also, 3) it is far too dependent on the likelihood of a reasonable agreement with the majority of bondholders to be a first best solution to countries facing over indebtedness. So a formal bankruptcy or debt resolution mechanism is preferable over a solution that simply involves collective action clauses.

#### 1.5.4. Our Recommendations

Changing debt contracts has significant friction costs. Messy restructuring, in particular, involves significant economic pain both for creditors and debtors, and involves large deadweight losses. That is why it would be much better to put in place a predictable and independent sovereign debt resolution mechanism *ex ante* so that this can play a disciplining role in crisis prevention as well and enable a more efficient and fairer burden sharing.

This is the best way to deal with sovereign solvency problems of the kind faced by Greece and Ireland, especially as long as the no bailout clause exists and prevents other countries from picking up the tab. This in any case would be dangerous under the current political climate, when resentment against Greece in other Member States is at an all time high.

The (direct) burden sharing has to be between the public and the private sector even if this might mean that other EU governments would then face a fiscal burden in order to recapitalize their private financial sector. This would be disciplining, reduce moral hazard, give these EU governments the opportunity to assert more control on their financial institutions including by changing management and it would be technically compatible with the no bailout clause in the EU treaty.

While some discussions have suggested putting in place pan-EU debt restricting mechanism, we believe that it would be strange, perhaps even irresponsible, to put in place a mechanism that applies to the EU alone, especially when poor developing countries have been (and will be again) in far greater fiscal trouble. Under the current fiscal scenarios, it is not just poor developing countries but several other rich countries such as Iceland that are in much worse shape than most euro area countries. Plus, it risks sending negative signals to the market that it is only euro area countries that can default.

Countries in the developing world are much more likely to need restructuring of their debts to other governments, multilateral organizations and the private sector. It would be a missed opportunity and go against the principles of coherence with development policy that are part of EU policy if the sovereign debt restricting mechanism the EU supports will not be open to developing countries. This is the third reason for putting in place an international rather than an EU specific mechanism.

The international environment has changed from 2002 and the IMF might be more acceptable this time round. Failing this, the BIS may be another interesting option. Or an independent arbitration panel or legal mechanism set up under the aegis of the UN with international statutory authority.

### **BOX: Instituting an International Debt Restructuring Mechanism (IDRM) for Crisis Resolution**

The first best choice is for the EU to revive discussions on an international sovereign debt restructuring mechanism. The IMF's proposed SDRM, the US Chapter 9 model, Paris and London club restructurings, Brady bond restructurings and several other voluntary restructurings and defaults offer a series of instructive lessons on the best design for such an international mechanism.

An IDRM:

- 1) should be based on principles of burden sharing contained in the chapter 9 municipal bankruptcy code of the United States
- 2) extensively use GDP linked bonds and Eurobonds as exit instruments
- 3) operate quickly targeting the timeline for a sovereign bankruptcy of less than 6 months
- 4) make provision for adequate debtor in possession financing
- 5) use an independent panel of experts who are supported by a dedicated secretariat
- 6) address both loans and bonds
- 7) cover liabilities owed to both private and public entities and
- 8) operate under the aegis of a respected international body with a statutory status

*Source: Tackling Sovereign Debt Systematically, Re-Define, 2010*

### **BOX: Tackling Greek and Irish Debt Problems in the short term**

While setting up an IDR is a longer term project, the need to restructure Greek and Irish debt is urgent. That is why we believe that these restructurings should happen in 2011 and the IDR can be instituted from 2013. The current EU discussion on the introduction of Collective Action Clauses is completely inadequate and will fail the test of the market exactly when most needed.

A default by sovereigns will have a large friction cost that creates deadweight losses and is usually very time consuming, especially in the absence of a formal institutional mechanism to deal with sovereign bankruptcy. Developing countries such as Jamaica have successfully restructured their bonds voluntarily. Such an option should be considered for Greece and Ireland especially if the political will to institutionalize a formal sovereign bankruptcy mechanism cannot be mustered.

Under such a scenario payment terms on outstanding debts that would include both bonds and loans can be changed so as to reduce the effective burden of debt, often without triggering formal default. This helps avoid the friction costs associated with such an event. Lengthening the maturity period and reducing the interest rate payable are the two main tools that can a country mitigate its debt burden.

Here, there are a number of lessons that can be learnt from the Brady bond restructurings of the 1970s. Issuing bonds guaranteed by other EU countries or a mechanism such as the EFSF in exchange for existing Greek bonds with an implicit haircut of 30%-50% would be a good way forward. It may not be possible to avoid a reduction in face value and a formal default for such levels of haircuts but that should not stop policy makers from pursuing this option.

Introducing a GDP linked payment component into these new bonds would further help reduce upfront costs for Greece without damaging longer term economic growth prospects. Market surveys indicate a growing appetite for such bonds.

Greece can make this process efficient by introducing a domestic law on collective action and aggregation of outstanding Greek bonds more than 90% of which are issued under Greek law. If it fails to get enough creditors on board, Greece should introduce changes to its domestic law that forcibly bring creditors to the table for a reasonable deal.

Ireland is in trouble because its governments issued an "irrevocable" guarantee on senior bank debt. When Irish banks faced tens of billions of Euros of losses, the state faced a sovereign debt crisis. The new Irish government (after the forthcoming election) should revoke this "irrevocable" guarantee and force senior bondholders of banks into a debt equity swap. This would not only solve Ireland's sovereign debt problem but would also make its weak banks amongst the most well capitalized banks in the world.

In case the revocation of the guarantee turns out to be legally more complex than it currently seems, Ireland should take the Greek route suggested above. More detailed proposals on this are presented in our paper "How to exit the Euro Crisis".

*Source: Tackling Sovereign Debt Systematically, Re-Define, 2010*



## 1.6. Conclusion

The objective of this Part I contribution is two-fold, 1) to put forward a comprehensive crisis management framework 2) and to make policy suggestions improving the various elements that comprise this framework.

In this part we have shown that, in order to be complete, a crisis management framework will need to have three distinct but inter-related elements 1) prevention 2) mitigation and 3) resolution. Furthermore, we have highlighted how the policy discussions in the EU on the handling of sovereign crisis have thus far focussed their attention mostly on prevention and mitigation with no serious discussion of provisions for resolution.

The part has also exposed how the ongoing discussions on crisis prevention are based on unrealistic and flawed assumptions. We have attempted to make serious new suggestions on how to improve the crisis prevention framework within the euro area which are based on a more realistic interpretation of the political economy of policy making in the euro area.

The policy measures adopted by the EU on crisis mitigation, which is where the firepower of the ECB and the EU has been concentrated, while substantial, still have room for improvement. We have put forward a number of concrete measures that could be taken in this regard. Detailed options for this are discussed in Part II and Part III of this paper.

Finally, we provide some ideas on building crisis resolution tools as a means of completing the euro area crisis management framework.

## **2. PART II: IMPROVING THE EUROPEAN FINANCIAL STABILITY FACILITY (EFSF)**

### **2.1. Abstract**

The current capital and operational structure of the EFSF is highly inefficient and has led to growing calls for an urgent expansion of its capacity. This Policy Maker brief offers four distinct standalone but complementary suggestions on how its capacity could be increased with three of the suggestions not needing any additional commitments from Member States.

These measures can be used on a standalone basis or in various combinations with each other. If used together, they have the capacity to increase the effective capacity of the EFSF to more than €1,000 billion – a quadrupling of capacity, without much additional commitments from Member States. If additional Member State commitments are ruled out, the other three measures can still increase the capacity of the EFSF to as much as €750 billion. The switch to providing partial guarantees by itself can instantaneously increase the capacity of the EFSF to more than €500 billion, a doubling of its current effective capacity of about €250 billion. (Note the preferred creditor option probably does not sit very well with the partial guarantee option.) We also strongly recommend that the EFSF should charge Member States only on a cost recovery basis.

### **2.2. Background**

The European Financial Stability Fund (EFSF) has a notional size of €440 billion as defined by Member State Commitments. It is structured as a “société anonyme” under Luxembourgish law and has been operational since August 2010 with the Euro area Member States as its shareholders.

The EFSF is backed by guarantees from member states in proportion to their ECB capital subscription with each member state being responsible for 120% of its share of EFSF commitments so the total size of the guarantee provided works out to be €440 billion.

In its effort to seek a AAA credit rating the EFSF employs three tools

- 1) An over guarantee from Member States that amounts to 120% of their EFSF commitments
- 2) A cash reserve set aside from borrowers plus a service fee
- 3) A loans specific cash buffer

The AAA rating comes from all borrowing being backed by either a guarantee from a AAA rated country (1 above) or by AAA assets held by the EFSF (2 and 3 above are invested in AAA bonds and notes).

FIGURE: The size of the EFSF					
Country	Fitch Rating	Share of EFSF	Size of Guarantee	GDP (2010)	Guarantee as % of GDP
Austria	AAA	2.90%	13	281	4.54%
Belgium	AA+	3.60%	16	352	4.50%
Cyprus	AA-	0.20%	1	17	5.18%
Finland	AAA	1.90%	8	178	4.70%
France	AAA	21.30%	94	1948	4.81%
Germany	AAA	28.40%	125	2498	5.00%
Greece			0	229	0.00%
Ireland			0	156	0.00%
Italy	AA-	18.70%	82	1548	5.32%
Luxembourg	AAA	0.30%	1	40	3.30%
Malta	A+	0.10%	0	6	7.33%
Netherlands	AAA	6%	26	585	4.51%
Portugal	A+	2.60%	11	171	6.69%
Slovakia	A+	1%	4	66	6.67%
Slovenia	AA	0.50%	2	36	6.11%
Spain	AA+	12.50%	55	1051	5.23%
<b>Total</b>		<b>100%</b>	<b>440</b>	<b>9,162</b>	<b>4.80%</b>

*Based on Data from Fitch Ratings, EFSF, ECB, Eurostat*

As can be seen from the table above, more than 60% of the backing for the EFSF is from Member States with a AAA rating, more than 35% from Member States with a AA rating and less than 5% from Member States with a A rating.

The second point of note here is that the size of commitment as Member State GDP is small but significant lying in the range of roughly 3%-7% of Member States GDP.

A third point that stands out is that the % of GDP commitment from larger Member States is on average lower than the commitment from smaller Member States.

### 2.3. Does the EFSF have insufficient capacity?

Because the Member State Guarantees are supposed to be 120% of the EFSF commitments, it follows naturally that the maximum capacity of the EFSF to provide support is already diminished to €367 billion. Once further adjustments are made for all loans to be backed by AAA guarantees or AAA assets this further diminishes to around €250 billion-€270 billion, only about 60% of the headline number.

Another complication is that Member States which draw on the EFSF also withdraw the guarantees they have provided to the vehicle. This means that every time a new Member State accesses the facility, it not only diminishes the unused part of the facility but also reduces the overall size of the EFSF. Portugal and Spain, widely seen to be the next in line for EFSF support together account for 15% of the size of commitments a significant amount.

At a size of €250 billion the EFSF is rightly perceived by markets to probably be insufficiently large in order to fulfil the need to support any of the larger Member States should they need to draw on the facility. We estimate that if Portugal and Spain also need support then the EFSF will fall short by about EUR 150 billion. That is why there is an earnest on-going discussion about the need to expand the size of the facility.

Many Member States are reluctant to provide additional support or guarantees for the EFSF so any tool that can help increase the effective size of the support the EFSF can provide without increasing the commitments from Member States would be very welcome.

## **2.4. Options for expanding EFSF capacity**

The capacity to provide support can be increased by four distinct sets of measures:

### **2.4.1. Changing the formula for the Guarantee**

As discussed above, under the ECB capital share criteria, the larger Member States have, on average, lower commitments compared to the smaller member states. If we take the 7% of GDP maximum level of commitment from smaller states as a new benchmark and change the EFSF's funding criteria so each Member State provides 7.5% of its GDP in guarantees the nominal size of the EFSF increases to about €660 billion, a 50% increase in size. It also increases the share of AAA commitments from 60.5% to 63% so will increase the real effective lending capacity of the EFSF to about €370-€390 billion a substantial increase under the current structure while retaining its AAA credit rating.

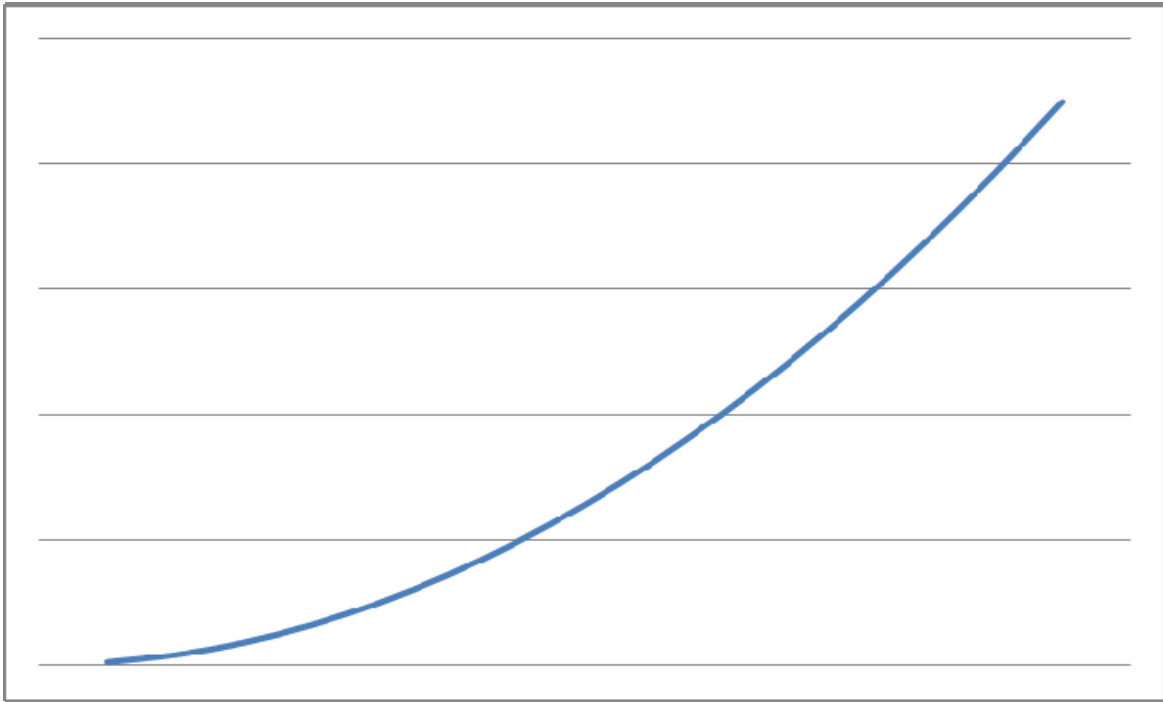
This would be a more equitable burden sharing across states and would provide for the needed boost to size without affecting the AAA rating that is so cherished by EU policy makers. However, there is a reluctance on behalf of Member States to provide additional commitments.

### **2.4.2. Going for AA not AAA rating**

Even at the time the structure of the EFSF was being discussed we questioned the need for a AAA rating on efficiency grounds. Subsequent events have only increased our doubts about the need for the EFSF to target a AAA rating.

Seeking AAA rating was justifiable on two grounds 1) reputational and 2) in order to lower the cost of funds. The thinking was that if the European Union, one of the most credit worthy regions in the world, could not design a multilateral vehicle that enjoyed the highest credit rating that might cause some reputational damage. This line of reasoning has some merit in it but a good case can be made that the incoherence of policy making and delayed responses to recurring crisis are far more significant. EU policy makers should be willing to consider jettisoning the AAA rating.

The second justification, of lower borrowing costs, is on even thinner ground. First, the borrowing costs increase only very slowly down the rating scale and the difference between AA and AAA is very small with the difference in borrowing costs between A and AAA larger but still close to the 1%-2% mark depending on market conditions. As the following graph shows, borrowing spreads increase rather slowly at first and then more rapidly down the rating scale. Most important, by setting the interest rate at which funds will be made available to Ireland at close to 5.8%, the EFSF is not passing on the low cost of borrowing it is expected to enjoy because of the AAA rating to borrowers so the justification for the inefficient use of the capital structure to achieve this rating is not defensible.



*Figure: The graph shows how bond spreads typically evolve as one goes down the rating scale*

If the EFSF were to agree to settle for a AA rating, its lending capacity can be instantly increased from about the current levels of €250 billion-€270 billion to more than €400 billion without any increase of commitments on behalf of Member States. This is a boost of more than 50%. We strongly believe that this is a step policy makers should instantly consider. In fact, in discussions at the next Euro group meeting the possibility of targeting not just a AA rating but an even lower rating of A should not be dismissed.

That having been said, we believe that the biggest efficiency gain for the EFSF will come from a move to a AA capital rating that would not only allow for a significant expansion of the lending capacity of the EFSF but will also allow it to borrow at spreads that are very close to the cost of funds under a AAA rating. Moreover, we firmly believe that the EFSF should on-lend to troubled Member States on a pass through basis after making deductions for operational and administrative expenses.

*This would address the very pertinent objections raised by many commentators including ourselves of the logic of current high lending costs to troubled countries such as Ireland that only help exacerbate the problems being faced by these Member States.*

#### 2.4.3. Introducing a Preferred Creditor Status for the EFSF

We believe that the decision not to grant a preferred creditor status to the EFSF was flawed. As we have discussed elsewhere, creditworthiness for a facility such as the EFSF can come from one of two fronts 1) the strength of liabilities (capital or guarantees) or 2) the safety of its assets (ensuring that loans will always be repaid) or a combination of the two.

The EFSF mistakenly went for an extreme version of 1 by deciding not to ask for a preferred creditor status. However, for the same level of capital and guarantee commitments, an EFSF that has a preferred creditor status would be seen to be much more creditworthy than an EFSF that does not enjoy such a status.

The corollary to this is that for a given level of capital and guarantee support (€440 billion), the EFSF can significantly increase its lending capacity while retaining its credit worthiness if a preferred creditor status is introduced. While a statutory provision is preferred as we have explained elsewhere, even a non-binding clause in the MoU between the borrowing Member States and the EFSF can significantly increase its immediately capacity to lend by tens of billions of Euros.

#### **2.4.4. Providing Bond Guarantees not Loans**

The current operation of the EFSF, whereby it first borrows in the financial markets and then lends funds to Member States in the form of loans is highly inefficient from the perspective of both transaction costs and the use of its balance sheet.

As we highlighted in a 2010 paper for the European Parliament (Building a Crisis Management Framework for the EU), a much more efficient use of the balance sheet of the EFSF would have been to guarantee new bond issues by troubled Member States. These bonds could be issued with maturities of anywhere between 1-5 years and enjoy any degree of guarantee between 100% on the one hand and much lower amounts on the other.

Given the expected losses the market seems to be factoring in on Greek and Irish Debt we recommend that the EFSF guarantee new Bond Issues from Troubled Member States against the first 40% of losses. This would have the instantaneous effect of 1) restoring capital market access for troubled Member States, 2) significantly lowering the borrowing costs they face, and 3) more than doubling the effective size of the EFSF to more than €500 billion instantaneously.

## **2.5. Conclusion**

We strongly recommend that the EFSF 1) shift to guaranteeing the 40% of losses on new bond issues by troubled Member States and 2) target a lower AA rating.

We recommend also that the EFSF seek a preferred creditor status in its MoUs with troubled Member States.

We suggest that if a decision is made to expand the size of commitments for the EFSF, then these be driven by a shift to a % of GDP formula which is more equitable across Member States and addresses some of the imbalance between smaller and larger Member States under the current quota system. Moreover, we recommend targeting a size of 7.5% of 2010 GDP.

We also strongly recommend that the EFSF lower the cost of provision of support to a purely cost recovery basis.

### **3. PART III: DESIGNING THE EUROPEAN STABILIZATION MECHANISM (ESM)**

#### **3.1. Abstract**

In this Part III of the paper we address ESM design issues relating to its 1) legal structure and status, 2) funding model, 3) credit rating, 4) size, 5) preferred creditor status, 6) governance and operational structure, 7) decision making process, 8) toolkit of instruments to aid Member States in trouble, and 9) existence within a broader framework of EU crisis prevention and crisis resolution.

#### **3.2. The Legal Basis and Form of the ESM**

There are three main models for the legal form the ESM could take. 1) The first is that of a statutory EU institution either deeply embedded in the EU such as the European Investment Bank (EIB) or a more light touch creation such as the recently created European Banking Authority (EBA). 2) The second model is that of creating an international public law entity in the form of a treaty based international financial institution such as the European Bank for Reconstruction and Development (EBRD). 3) The third possibility is that of setting it up as a private entity with the European Financial Stability Facility (EFSF) that has the legal form of a 'society anonymous' under Luxembourg law as a model.

All of these structures come with their particular advantages and disadvantages. However, for the important Crisis Mitigation role that the ESM is expected to fulfil in the EU, we believe that a statutory form under Community law would be the most credible. It will also mean that the ESM will be accountable to the European Parliament, which will increase the transparency and ensure that its work will be well scrutinized. This structure might create some complications because only Euro Member States will have a real stake in its work but these can be resolved in a number of ways.

A second best, but perhaps more realistic solution given the politics involved, would be to set up a treaty based international financial institution aka the EBRD with Euro Member States as shareholders. The EBRD itself was created on a fast track time table in less than 18 months between conception and launch so an even shorter timetable for the ESM is definitely possible. Care should be taken to have an easy scope for both 1) expansion to include new Euro members and 2) the possibility of an ad hoc non Euro Member States participation on a case by case basis.

We do not recommend the use of an EFSF like legal structure because a non-statutory entity is less suitable for the size and importance that the ESM will have and there are few precedents for the use of a private entity for interstate action at this scale.

It is planned that the legal basis for the ESM will be provided by the insertion of the following clause into Article 136 of the TFEU.

"The member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality." This, as we will see in a subsequent section, imposes serious constraints on what the ESM may be able to do.

### **3.3. The Size**

The ESM should have a substantial capacity for providing liquidity support to troubled member states so that it can carry out operations in multiple member states simultaneously. This would seem to indicate the need for a very large size. However, it is important to remember that the ESM (in contrast to the EFSF) is likely to operate purely as a short term liquidity support facility. This means that the time horizon of any lending operation will be short.

So the ESM should have a size that would allow it to provide liquidity support to multiple member states but only for short periods. 1-2 years is a reasonable time frame for debt restructuring that might be needed for some of the member states in crisis and a good estimate of the time needed to overcome a liquidity crisis. So a good base funding scenario would be the ability to support a third of the Euro zone borrowing needs for a period of 1-2 years.

Eurozone government borrowing will be in the range of Euro 7-9 trillion in the near future and currently has an expected average maturity of 5-7 years. This puts annual financing needs for the Eurozone at more than Euro 1 trillion so the targeted size of the ESM (1/3 of needs for 2 years) should be Euro 600-750 billion.

No matter what size policy makers choose at the launch of the ESM, it is important to provide an upward flexibility that can handle contingencies.

### **3.4. The Funding Model**

We suggest that the ESM have a three tier funding structure 1) a small amount of paid in capital 2) substantial pro-rata guarantees or callable capital from Euro Member States that provide the main source of strength for the operation of the ESM 3) an accumulation of own resources through any operational profits.

The ESM, if it is set up as an International Financial Institution as we recommend, should have some paid in capital that should be minimised given the toughness of the prevailing fiscal climate and for efficiency considerations. We believe that a paid in capital base of between 1% and 2% of intended size would be appropriate. In particular, because the ESM will operate only as an emergency facility and will not have any on-going operations that necessitate the use of capital, it makes sense to minimise the use of paid-in capital on efficiency grounds. It is useful to look at the European Investment Bank as a benchmark. It has a subscribed capital base of EUR232.4bn of which only 5% is paid in.

For the ESM, this can come in the form of 1) direct transfers by Member States 2) left over profits (if any) from the operation of the EFSF when it is wound up 3) transfers of fines envisaged under the Excessive Debt and Excessive Imbalance procedures of the EU 4) levies on financial institutions or 5) financial transaction taxes. In general a diverse set of funding sources that can draw on both the private and the public sector makes sense.

The bulk of the firepower for the ESM will come in the form of callable capital (or Member States guarantees) where Euro Member States agree to provide irrevocable guarantees to meet any liability of the ESM in a timely manner. This model is the work horse for International Financial Institutions most of which derive their creditworthiness from the size of the total subscribed capital base (paid in plus callable) that can be attributed to highly rated (AAA or AA) sovereigns.



There have been suggestions (from Eurobond advocates, some academics and from Citicorp) that the guarantees provided by Euro Member States to the ESM should be 'joint and several' where each Member States is responsible for the whole amount of the guarantee rather than the amount pro-rated according to a quota system. This, it has been suggested, will improve the creditworthiness of the ESM.

We believe that such 'joint and several guarantees' which underpin the liabilities of the European Commission, are completely unnecessary for the ESM and are potentially dangerous for smaller Member States. Given the high proportion (more than 90% under any feasible quota share arrangement) of Member States commitments that will be AAA or AA rated, there is no need for the ESM to seek a 'joint and several' guarantee model. The ESM, as demonstrated by the very high ratings achieved by IFIs such as the EIB, EBRD, the World Bank (IBRD) etc. can be credit worthy under the same paid in/callable capital model.

Indeed joint and several liability for the ESM would potentially impose a liability on smaller Member States that is a big multiple of their GDP. For example, under an extreme scenario, a small country such as Malta can be held liable for the whole of the ESM. So the ESM should follow a pro rata model for callable capital/guarantee from Member States. What should this quota be based on?

Here there are two models 1) the ECB where Member States quotas are based on an average of population weights and GDP weights and the 2) EIB where Member States quotas were decided roughly on the basis of the size of their GDP at the time of accession. Of these, the ECB system that has also been used for the allocation of guarantees for the EFSF imposes significantly higher burdens on smaller and poorer Member States.<sup>3</sup>

We believe that the ESM quotas should be based on 'capacity to pay' for which we recommend the use of Member States GDP as a proxy. Member States quotas should be allocated in proportion to their 2010 GDPs.

### **3.5. Credit Rating and Funding Needs**

As we will see in a subsequent section, we recommend that the ESM work differently from both other IFIs and the current model for the EFSF. Unlike these institutions which borrow money in capital markets and then on-lend it to eligible borrowers, we believe that the ESM should work mostly through guaranteeing bond issues by Member States in financial trouble. As we will see later, this has several advantages. This means that the ESM is not likely to need to borrow substantial sums in the bond markets though it should be flexible enough to do so if needed.

In any case, bond investors need to be assured that any funds provided to the ESM or underpinned by guarantees from the ESM will be repaid. This is the only instance under which they will be willing to provide funds at a cost low enough for the ESM to be able to fulfil its Crisis Mitigation mandate.

This assurance comes from two sources 1) ensuring the safety of repayments by troubled member states 2) ensuring the availability of adequate capital, and/or legally binding guarantees by Euro member states so that investors would get repaid even under a scenario of the troubled member state being unable or unwilling to repay the liquidity support it has received from the ESM. These two forms of assurance, on the asset and liability sides of the balance sheet of the ESM respectively, are mutually reinforcing and to some extent mutually substitutable.

<sup>3</sup> See Kapoor, Sony: "Improving and Expanding the EFSF, Re-Define 2011.

This means that the ESM can achieve a desired high creditworthiness through one of three routes 1) a very strong repayment protection with relatively weak capital/guarantee support 2) a strong commitment to repay combined with strong capital/guarantee support and 3) a relatively weak repayment protection combined with a very strong capital/guarantee support.

Of these, option 1 is most efficient in the sense that it would require the lowest upfront commitment of capital and guarantee from member states. For IFIs such as the EIB, this is achieved at least partly through having a well-diversified and safe lending portfolio. This is obviously not an option for the ESM which by the nature of its mandate will have large concentrated and risky credit exposures. This can be achieved with a strongly enshrined preferred creditor status for the ESM so repayments of ESM funds even by troubled member states are assured. This is the approach we recommend and is discussed more completely in the subsequent section on preferred creditor status.

Option 2 may be achieved with a less strong (non-statutory) preferred creditor status that is taken to be customary but is not backed by the letter of law. This will require significantly stronger (read higher) capital and guarantee support from member states compared to option 1 for any given size of the fund.

Option 3, where there is no preferred creditor status, may end up looking like the current form of the EFSF which needed a convoluted and inefficient structure of excess guarantees, locked in collateral and lower lending capacity in order to obtain an AAA credit rating.

We believe that option 1 would be most suitable for the mandate of the ESM.

The next major question to address is what, if any, credit rating the ESM should target. Unlike the EFSF which needs to borrow funds in the private markets the ESM is likely to concentrate on issuing guarantees. This means that obtaining a credit rating is less important for the ESM. However, the spread payable on Member States bonds guaranteed by the ESM will be linked to its credit rating so the ESM will need to seek a rating. What should this targeted rating be?

We believe that policy maker obsession with a AAA credit rating is overdone but may be understandable in the context that an EU institution with a less than sterling credit rating may carry some reputation risk.<sup>4</sup> For example, the convoluted model followed by the EFSF<sup>5</sup> in order to achieve an AAA credit rating is not very efficient. It seriously limits the effective size of lending and increases effective costs for borrowing Member States. That is why, we believe that the ESM should only seek an AA rating.<sup>6</sup>

Assuming a size of Euro 750 billion, we recommend that the ESM be launched with a paid in capital of Euro 7.5 billion – Euro 15 billion. The callable capital guarantees/ needed for a AA rating will then be in the range of Euro 400 – Euro 500 billion assuming that the majority of the ESM's operational support will be provided in the form of partial guarantees protecting investors against the first 40% -50% loss for Member States bonds guaranteed by the ESM (see section on instruments of support and the Policy Maker brief "Improving and Expanding the EFSF, Re-Define 2011" for more detail.

Thus the present Euro 440 billion level of Member States guarantees provided for the EFSF seems like a reasonable starting point for the ESM.

---

<sup>4</sup> As we have explained in detail in our policy maker brief "Improving and Expanding the EFSF", Re-Define 2011.

<sup>5</sup> Discussed in detail in the paper mentioned in the footnote above.

<sup>6</sup> A detailed discussion on this can be found in "Improving and Expanding the EFSF", Re-Define 2011.

### 3.6. Preferred Creditor Status

As discussed briefly in the preceding section on the funding model for the ESM, the place accorded to the ESM in the hierarchy of creditors is one of the most important parameters that will determine the credit worthiness of the ESM.

Internationally, multilateral institutions such as the World Bank, the IMF, the EBRD etc. are widely believed to enjoy a preferred creditor status that ranks them above all other creditors for sovereign borrowings in particular. This status, which is not backed anywhere by the letter of law is customary in nature and is driven by a number of factors such as 1) default on multilateral commitments can cut off all important access to further funding/support from these institutions which is a highly undesirable scenario 2) multilateral financial institutions such as the IMF often provide funds to countries that are in financial trouble so their financing can be seen to be a form of 'debtor in possession financing' that is made available to private companies under bankruptcy proceedings and does enjoy a statutory preferred creditor status and 3) the reputational risk of being considered to be a 'pariah state' is very real and can carry real political and even economic costs.

For these reasons, no country has, till date, defaulted on their commitments to institutions such as the IMF and the World Bank. (Another is that the multilateral organizations have used creative accounting techniques so as to avoid recognizing even much delayed payments as a default).

This status, as far as we know, has also not been tested in courts. In fact there has been some ambiguity about the existence of this preferred creditor status including doubts expressed by the auditor general of Canada. This preferred creditor status one of the drivers behind the relatively high credit worthiness enjoyed by many multilateral institutions than would be justifiable for an equivalent financial exposure by a private financial institution. In the words of the International Finance Corporation, part of the World Bank group, its "preferred creditor status is not a legal status, but it is embodied in practice and consistent universal recognition. It is granted by member governments of IFC and recognized by other creditors. It is also an important element in IFC's triple-A ratings."

The strongest form of a preferred creditor status is one that is statutory in nature being backed by the letter of law. This is the kind of status that is enjoyed by providers of 'debtors in possession financing' under the US Chapter 11 bankruptcy code.

Because of the uncertainty associated with the legal validity of a non-statutory preferred creditor status that the Member States seem to be aiming at, it is almost certain that the creditworthiness of the ESM will be lower and the borrowing costs for the ESM will be higher than these would be under a preferred creditor status that is backed up by the letter of law. Given the scarcity of Member State funding and the natural reluctance of Member States to provide more callable capital or guarantees than strictly necessary, it would be imprudent to not to fully exploit the credit enhancement that a statutory preferred creditor status can bring the ESM.

That is why we strongly recommend that the preferred creditor status of the ESM be firmly enshrined in Community law. The understandable desire of Member States, due to the customary subordination of regional multilateral creditor interests to international multilateral creditor interests, to rank the ESM behind the IMF can be easily tackled by providing for this in the same piece of legislation.

It has been suggested that the preferred creditor status enjoyed by the ESM may lead to a sharp withdrawal by private lenders who fear that their claims get subordinated as the size of support from the ESM increases. This may lead to private investors shunning any country that accesses the ESM.

This is a legitimate concern but is not much supported by historical evidence. It has been shown that the involvement of the IMF as a provider of liquidity support has increased the final payments that have accrued to private creditors of troubled emerging markets where the IMF provided substantial support. By ensuring the continuing availability of funds at a reasonable cost, a liquidity provider of last resort can help increase the overall size of funds available for repayment to private creditors compared to the alternative scenario of countries being unable to borrow at reasonable costs which can trigger large deadweight economic costs that reduce the likelihood of repayment.

Another important point is that the ESM under most scenarios is only likely to temporarily replace borrowing that under other scenarios would have happened in the markets at a higher cost. So the existence of the ESM as envisaged is unlikely to increase the overall debt to GDP ratio of a country but should reduce its overall cost of servicing debt compared to alternative scenarios.

The final point here is that the ESM can be designed in a way that concurrent lending by the private sector may be treated *pari passu* with the ESM because it can be seen to be conceptually similar to the 'debtor in possession financing' we have referred to in a previous section. This can ensure continuing market access for the Member State and can make exit from an ESM program easier.

Another even simpler way of achieving the same outcome can be by using the date of the first ESM access by a Member State as the cut-off date for any restructuring of debt that might be required if Crisis Mitigation measures prove insufficient.

### **3.7. Governance and Organization**

The ESM, as currently envisaged, will support Euro area Member States facing financial trouble and in turn will be backed by all Euro area Member States. It is appropriate then that the ESM have a board of governors comprising Euro group ministers of finance. The board can then appoint (part time) Executive Directors who, as in the case of the IMF, are likely to be senior finance ministry officials from Euro Member States.

The ESM is expected to have a highly variable work load with long periods of inactivity interrupted by occasional bursts of hyperactivity. Having a big staff would be extremely inefficient as they would have nothing to do most of the time. That is why the ESM should go for a model that has a small secretariat that is supported by a network of competent officials and experts from Euro area finance ministries, debt management offices, central banks and EU institutions as needed. The ESM should also have the flexibility to draw on expertise of the private sector if needed.

In addition, it is envisaged that the ESM will maintain close relationships with the European Systemic Risk Board (ESRB), the ECB, the European Commission, the IMF and Euro member Finance Ministries and Debt Management offices to help it with 1) Monitoring 2) Analysis and 3) Operations.

### 3.8. Decision Making Process

As currently envisaged, the ESM would work in the following way:

1) A euro area Member State facing financing difficulties, would make a request for support to the Euro group and the IMF 2) The Euro group would then ask the Member State to discuss its possible financing needs, together with a draft macroeconomic adjustment program, with the Commission, the ECB and the IMF 3) The Commission (together with the ECB and the IMF) would assess the program and forward its analysis and recommendation to the Euro group 4) The Euro group would assess whether the problems faced by the Member State is one of solvency or liquidity and would take a unanimous decision on the program which would then be forwarded to the European Council and a MoU would eventually be signed by the Commission on behalf of the Member States.5) The Euro group would then decide the main terms of the facility under which Member States are supported 6) Compliance with the policy conditions will be monitored by the Commission in liaison with the ECB

This process 1) sounds convoluted 2) is likely to be time consuming 3) involves far too many actors 4) has too many stages and 5) needs to pass through the high threshold of unanimity in the Euro group. Another complication is plan to make an upfront decision on whether the Member State problem is one of liquidity or solvency, something that is very hard to make a judgement call on ex-ante.

This decision making process is not conducive to quick decision-making that would be crucial for effective crisis mitigation. The uncertainty about the final outcome and the substantial time the decision making process is likely to involve seem designed to cause market jitters and trigger contagion rather than calming markets and preventing contagion the stated purpose of setting up the ESM in the first place.

Ideally, there should be automaticity in the availability of limited amounts of liquidity support from the ESM. Each member state should have a right of automatic access up to a limit of say 5% of GDP for a limited period of time say 6 months. A more stringent approval process by the Euro group (together with advice from the ECB, the Commission and the IMF) should kick in when the request for support exceeds 1) this minimum size or 2) is for a longer duration with conditionality increasing from none (for minimum access) to more substantial as the size and/or duration of the ESM support is ratcheted up.

The right to automatic access and the size of automatic access can be made conditional on the degree of compliance with the new enhanced stability and growth pact and macroeconomic balance obligations so it can also provide a positive incentive for 'good behaviour'.

The involvement of the IMF should be optional rather than mandatory. Given that Euro Member States are locked within the same monetary system there is a strong positive externality that derives from the provision of timely liquidity support to Member States facing financial stress. It can help minimise spill overs of financial stress and can effectively limit contagion. So there is a logical case for a graduated response that starts ex ante with the regional stabilization program but involves the international (IMF) stabilization program if the problems are serious and large enough to merit an international interest outside of the EU. The concurrent discussions on setting up global stabilization mechanisms and global safety nets are relevant in this regard.

So our suggestion is that 1) Member States have a right of automatic access to limited support from the ESM 2) that ESM support may go hand in hand with IMF involvement but that such involvement should not be mandatory 3) that the level of conditionality be proportionate to the size and duration of support sought by Member States 4) that the decision making process be simplified to fewer stages to allow for quick decisions 5) and that decisions for support be taken by the Euro group on the basis of a double supermajority (2/3 members and 2/3 quota of ESM support) to allow for more certainty in the decision making process.

However, this model for the ESM may not be fully compatible with the planned change to the treaty that specifies that "The member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

This seems to suggest that 1) automaticity is ruled out someone (the European Commission in consultation with the ECB and IMF) needs to make a judgement that the stability of the Euro area as a whole is under threat 2) strict conditionality is an integral part of the support.

If this specification of the treaty change is taken as a given, we need an alternative model for decision making.

Here we suggest that 1) the IMF should be treated as the liquidity provider of first resort with the ESM getting involved only if there is a solvency problem or if the magnitude of liquidity problems is large and affects multiple Euro Member States 2) the ESRB should also be authorized to kick start a ESM process if it perceives a systemic threat to the Euro zone as it is likely that given the strong conditionality, Member States will leave it far too long before they call on the ESM for help with a real possibility of negative spill-overs of their financial problems into other Euro Member States as contagion takes hold. (See decision flow chart in the Annex to this paper)

As we will see in a subsequent section, the use of guarantees rather than loans will also substantially speed up the working of the ESM.

### **3.9. Toolkit of Instruments**

For purposes of effective Crisis Mitigation, it is imperative that the ESM be provided with a diverse and broad set of instruments that it can use to support troubled Member States. Scrambling around for new means of support (as is happening in the case of the EFSF now) in the middle of a crisis is a recipe for contagion.

As our analysis below will show, we strongly believe that the ESM should use the provision of guarantees as the instrument of choice for supporting Member States in trouble. At a minimum, the ESM should be empowered with a toolkit that allows it to 1) provide partial or full guarantees for Member States bond issuance 2) provide loans 3) provide lines of credit 4) buy Member States bonds in the primary and secondary market and 5) finance buy back operations.

We strongly believe that there are several advantages to the EFSM/EFSS/ESM providing bond guarantees rather than loans. Some of these are 1) it eliminates (drastically reduces) the need for upfront capital 2) it reduces the pressure for a AAA credit rating 3) it can allow the ESM to leverage a given amount of Member States guarantees to support a much larger program by using partial guarantees 4) it eliminates (reduces) transaction costs associated with the provision of loans 5) it significantly speeds up the process of providing support to Member States as guarantees can be activated instantaneously 6) it allows for a smoother and more flexible and quick exit as guarantees are self-extinguishing 7) it allows Member States in trouble to retain market access 8) the spread between non-guaranteed and guaranteed bonds can provide a useful market signal for the reform process in the Member States 9) it reduces the scope for a double counting of outstanding Euro zone sovereign debt which can arise with the use of loans 10) guarantees are cheaper for the ESM to provide and for the troubled Member States to use than loans would be.

There is a qualitative difference between the provision of guarantees which do not require the ESM to mobilize upfront funds and the use of all the other instruments mentioned above all of which will mean that the ESM will need to mobilize funds.

There are many successful examples of bond insurance and credit enhancement. AMBAC and MBIA, two of the leading municipal bond insurers in the United States worked for several decades using a thin sliver of capital to provide credit enhancement to municipal bonds throughout the United States. The organizations went under only after they had abandoned their traditional model and started providing bond insurance to structured products that resulted in large losses when the financial crisis hit. However, the basic model of AMBAC and MBIA provides a good lesson for the design of the ESM.

Many EU member states ran very successful bond guarantee programs which can serve as a good basis for designing the guarantee program for the ESM. This can be seen in the Box: The EU Bond Guarantee Program for Banks in Part I of this paper.

### 3.10. Conclusion

In conclusion we recommend that the ESM

- 1) be set up as a treaty based international financial institution aka the EBRD with Euro Member States as shareholders;
- 2) has size at which it is able to meet around 1/3 of the Euro zone's annual sovereign debt issuance for a period of two years (Euro 600-750 billion);
- 3) is supported by Euro Member States providing a small amount of paid in capital (1%-2% of planned size or Euro 7.5-15 billion) and substantial pro rata guarantees (Euro 400-500 billion) in proportion to their 2010 share of Euro area GDP;
- 4) seek a AA not a AAA credit rating;
- 5) has a statutory preferred creditor status backed by the letter of law;
- 6) has Euro group finance ministers on its board of governors and senior finance ministry officials as executive directors and a lean secretariat that is able to draw on expertise from member Euro zone countries and EU institutions when needed. It should work closely with the IMF, the ESRB, the ECB, the EC and Debt Management Offices and Finance Ministries of the Euro Member States;

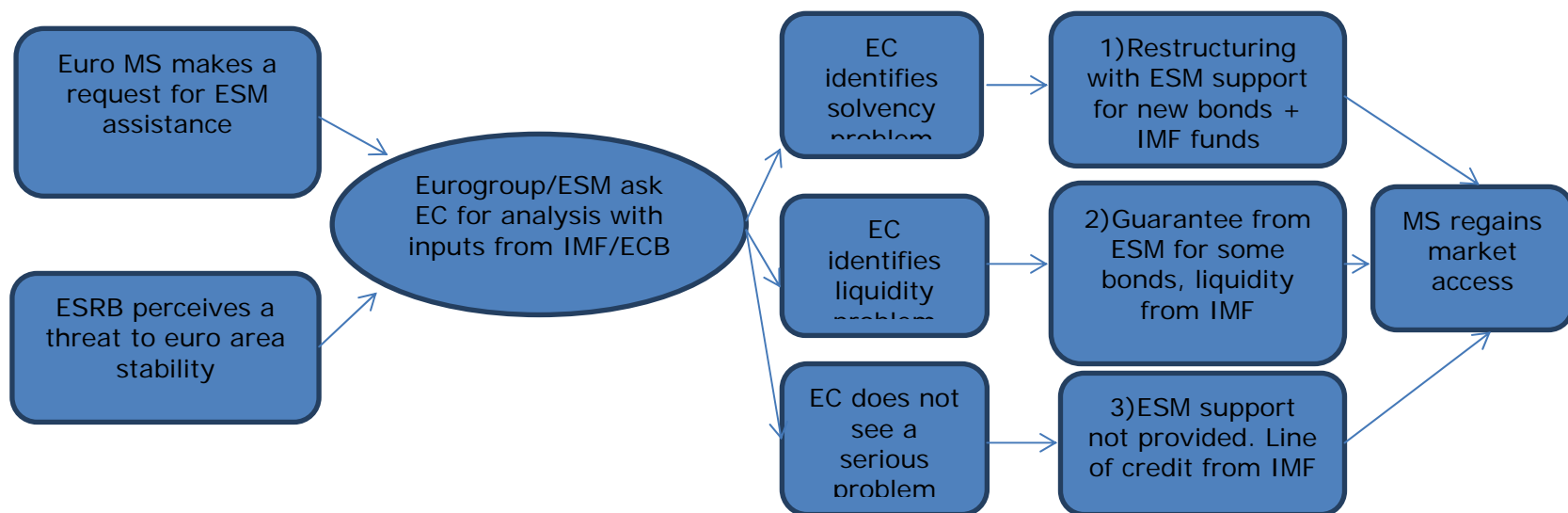
- 7) has a decision making flowchart conducive to quick decision making under pressure;
- 8) uses the provision of partial (against first loss) and full guarantees for troubled Member States bond issuance as the primary intervention tool with an additional flexible toolkit that includes the possibility of providing loans, lines of credit and bond purchase facilities.

## REFERENCES

- Kapoor, Sony: A crisis management framework for the EU banking sector, Re-Define (2011).
- Kapoor, Sony: The financial crisis - causes and cures, Re-Define Book (July 2010).
- Kapoor, Sony: Completing the euro area rescue: What more needs to be done, VOX EU Book (June 2010).
- Kapoor, Sony: Building a Crisis Management Framework for the EU, European Parliament, 2010.
- Kapoor, Sony: Improving and Expanding the European Financial Stability Facility, Re-Define Policy Maker Brief, 2011.
- Kapoor, Sony: An Optimal Design for the European Stabilization Mechanism, Re-Define Policy Maker Brief, 2011.
- Kapoor, Sony: How to Exit the Euro Crisis?, Re-Define Policy Maker Brief, 2011.
- Levy, Aviram and Panetta, Fabio: Government guarantees on bank funding: Should we extend them into 2010 despite improved bank profitability and the schemes' distortionary effects? Vox EU column, 2009.



## ANNEX TO PART III.: ESM FLOWCHART



Either the MS or the ESRB should flag disruptions in the sovereign debt market

EC responsible or analysis with inputs from IMF/ECB but Euro group decides

Euro group makes supermajority decision on 1 of 3 courses of action with MS permission

1)Restructuring +ESM+IMF  
 2)ESM guarantee +IMF funds  
 3)ESM no + IMF LoC or

Crisis mitigated / resolved

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

## POLICY DEPARTMENT ECONOMIC AND SCIENTIFIC POLICY **A**

### Role

Policy departments are research units that provide specialised advice to committees, inter-parliamentary delegations and other parliamentary bodies.

### Policy Area

- Financial, Economic and Social Crisis

### Documents

Visit the European Parliament website:  
<http://www.europarl.europa.eu/studies>



PHOTO: OBE DIE  
Shutterstock Images LLC

ISBN