THE EUROPEAN STABILITY MECHANISM

The global financial crisis has exposed major weaknesses in the design and implementation of the existing economic governance framework of the EU, and of the euro area in particular. The fiscal rules (laid down in the Stability and Growth Pact) have been weakened over time, and procedures and measures put in place to enforce economic policy coordination have not been implemented. The European Council of 24-25 March 2011 adopted a comprehensive package of measures to respond to the ongoing crisis, as well as to guard against such crises materialising in the future. The main features of this package relate to the strengthening of the preventive and corrective mechanisms to address internal and external imbalances, in particular fiscal imbalances and competitiveness problems of individual Member States, well before they might pose systemic threats. In addition, the package includes the establishment of a permanent crisis management mechanism as an ultima ratio safeguard against imbalances in individual countries. It is foreseen that the new European Stability Mechanism (ESM) will enter into force on 1 July 2013, following an amendment to the Treaty on the Functioning of the European Union (the Treaty) and the signing of an ESM Treaty by the euro area countries. This article outlines the underlying rationale for the establishment of the ESM and looks at its salient features.[1]

From the ECB's perspective, it is crucial that the existence, design and activities of the ESM do not create moral hazard, but rather strengthen the incentives for prudent fiscal and economic policies in all euro area countries. For this reason, it is essential that any financial assistance will be subject to very strict macroeconomic policy conditionality and be granted on non-concessional terms. Financial assistance must not act as a fiscal transfer, but only as a liquidity bridge that allows euro area countries in distress to "buy time" to take the necessary measures to restore fiscal sustainability and competitiveness in the medium term. The ESM would be activated if indispensable to safeguard financial stability in the euro area as a whole. It is therefore of the utmost importance that the range of measures focusing on crisis prevention and policy surveillance are well-designed and implemented in full so as to avoid the need to use the ESM.

1 WHY IS A PERMANENT CRISIS MANAGEMENT MECHANISM HELPFUL?

The institutional framework of Economic and Monetary Union (EMU) is unique.[2] EMU is a monetary union without a fully fledged political union. It is characterised by a single monetary policy set at supranational level (i.e. the euro area), a common market, and largely decentralised fiscal policies, which remain within the area of competence of the individual EU Member States but which are subject to rules-based coordination procedures, such as the Stability and Growth Pact.

The smooth functioning of EMU requires that national governments ensure the sustainability of their own public finances, the competitiveness of their national economies and the stability of their financial systems. Failure to meet one or more of these conditions over a sustained period of time reduces the net benefits of EMU and poses the risk of adverse cross-country spillovers. The Treaty contains two key provisions aimed at avoiding excessive debt accumulation at the national level and protecting the independence of the ECB: the "no-bailout" clause (Article 125) and the monetary financing prohibition (Article 123). These provisions preclude transfers and monetisation of government debt in the event of a debt crisis in a Member State. They will remain cornerstones after the reform of EU economic governance.

1 At the time of writing, the Treaty establishing the European Stability Mechanism (ESM Treaty) is still in the process of finalisation.

2 For a more detailed discussion of the institutional arrangements, see the article entitled "One monetary policy and many fiscal policies: ensuring a smooth functioning of EMU", *Monthly Bulletin*, ECB, July 2008 and the article entitled "The relationship between monetary policy and fiscal policies in the euro area", *Monthly Bulletin*, ECB, February 2003.

At the same time, the financial crisis has revealed major weaknesses and gaps in the existing governance framework. The fiscal rules (laid down in the Stability and Growth Pact) have been weakened over time, and procedures and measures put in place to enforce economic policy coordination have not been implemented. If these weaknesses and gaps were left unaddressed, the financial stability of the euro area as a whole could be put at risk. EMU is characterised by a high degree of economic and financial integration among its members, which in normal times is beneficial to all members. In times of crisis, however, close financial integration means that unsustainable developments in one member country can easily spread to others perceived as vulnerable by the market.

Strengthened fiscal, macroeconomic and macro-prudential surveillance is essential to guard against destabilising cross-country spillovers which might stem from a loss of confidence in the sustainability of national policies. The failure of the EU's economic governance to prevent and correct unsustainable national policies that contributed to the build-up of major imbalances in euro area countries has made the deficiencies of the overall governance framework all too apparent. This applies in particular to the weak implementation of policy recommendations, the inadequacy of enforcement measures taken to discourage or correct infringements, and the insufficient recognition by national policy-makers of the need to ensure consistency between national policies in a monetary union, especially with regard to competitiveness developments.[3]

The European Council, at its meeting on 24-25 March 2011, agreed on a number of important steps to reinforce the EU economic governance framework. The Stability and Growth Pact will be reformed to enhance the surveillance of fiscal policies and to foster the early application of enforcement measures. A new macroeconomic surveillance framework, including an enforcement mechanism, will be established in order to deal with internal and external macroeconomic imbalances at an early stage. In addition to these EU-wide proposals at the legislative level, a separate "Euro Plus Pact" has been devised among euro area countries, with an opt-in for non-euro area EU Member States, in order to improve competitiveness, foster employment, increase the sustainability of public finances and reinforce financial stability. These measures complement the strengthening of the supervisory architecture for the financial system that came into force at the beginning of 2011 with the establishment of the European Systemic Risk Board (the new EU body in charge of macro-prudential oversight) and the three new European Supervisory Agencies – the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority. Once fully operational, these measures should strengthen the economic pillar of EMU.

Strict observance of the Stability and Growth Pact, close surveillance of macroeconomic imbalances and effective economic policy coordination should provide a safeguard against crises of confidence of the type and magnitude that have been experienced in the recent past. However, to the extent that unforeseen external shocks can occur, the risk of crises can never be fully eliminated, in spite of strengthened fiscal and macroeconomic surveillance. For this reason, and in order to ensure the stability of the euro area as a whole, it was decided to also establish a framework which could provide temporary financial support to euro area countries, with the aim of providing bridge funding for the period of time needed to implement a deep adjustment programme to correct imbalances and regain market access. Any financing under the ESM needs to be subject to very strong policy conditionality.

The purpose of such a crisis management framework is to give euro area countries in distress the time necessary to implement measures

3 See the article entitled "The reform of economic governance in the euro area: essential elements", *Monthly Bulletin*, ECB, March 2011.

to restore fiscal sustainability, competitiveness and financial stability in the medium term. Financial assistance will only be granted if the country in question implements an adjustment programme capable of redressing the situation. Such an adjustment programme will in general include fiscal consolidation measures and structural reforms that address labour and product market rigidities, thereby improving the growth potential of the economy. While such measures will have some impact in the short term, their full effect often unfolds over the medium term. In this context, the financial assistance will serve as a liquidity bridge until the country in question regains market access. At the same time, financial assistance must be granted on non-concessional (i.e. sufficiently unattractive) terms to increase the incentive for the country to return to market financing as soon as possible. In addition, any financial assistance must be disbursed in tranches, conditional on the country's adherence to the targets laid down in the adjustment programme, so as to maintain the incentive for the country to continue to comply with the programme.

These design features of the European crisis management framework purposely resemble the main design features of the IMF-supported adjustment programmes. The nature of the balance of payments constraint is obviously different for euro area countries, which in this regard resemble regions within a larger state more than they do countries with their own currency. This is one reason why the EU does not have a balance of payments support facility for euro area countries, whereas such a facility does exist for non-euro area Member States.[4]

The creation of the euro area crisis management framework has been motivated by three main considerations.

First, even under a strengthened euro area governance framework, it cannot be excluded that external shocks might occur and that crises of confidence might develop which could have implications for euro area countries' access to market financing. For example, an exogenous shock of unprecedented magnitude might hit one euro area country asymmetrically, with profound implications for the country's domestic economic outlook. Given the greater propensity towards cross-country spillovers in a monetary union, and the lack of a central fiscal authority, such a shock could have the potential to destabilise the euro area as a whole (in the absence of a financial firewall). The potential for negative (and mutually reinforcing) feedback loops between the fiscal and financial sectors could be significant and both amplify and propagate the shock.

Second, there also remains the possibility of market failures in the financial sector, including self-fulfilling trend dynamics in the pricing of sovereign risk. Market failures are costly in a monetary union owing to the potential for contagion. The experience of euro area sovereign bond markets in recent years is telling in this regard. Prior to the financial market tensions in autumn 2008 euro area sovereign bond spreads were clustered in close proximity to each other, in spite of sizeable cross-country differences in underlying fiscal and structural positions. This underpricing of sovereign risk and, ultimately, failure of market discipline in a period of tranquillity quickly gave way to an abrupt and disorderly re-pricing of the risk, often – again – without due regard to different underlying fiscal and structural positions. The fact that market discipline was applied in a rather sudden and polarised manner also meant that, in this environment, a protracted liquidity crisis had the potential to become a systemic threat if left unaddressed. A crisis management framework would address such situations and thereby partly compensate for the fact that markets are imperfect devices for disciplining public policy.

4 The medium-term financial assistance facility (MTFA) is a Treaty-based instrument (Article 143 of the Treaty) that allows the EU Council to authorise the European Commission to borrow in capital markets and lend, under strict conditionality, to non-euro area Member States in financial difficulty. Current beneficiaries include Latvia and Romania.

Third, recent experience has also highlighted the need for credibility and predictability in crisis responses. A credible crisis management framework should help shape market expectations by providing clear "rules of the game" and thus influence the incentives for both private creditors and public debtors. These incentives are critically dependent on the design of the crisis mechanism, in particular on the extent to which it reinforces governments' incentive to adhere to sound national fiscal and macroeconomic policies and investors' incentive to correctly price the risk when lending to governments. If designed appropriately, it should also act as an additional dampener on the non-linear effects described above, in which sudden shifts in market sentiment can potentially turn tensions into full-blown crises.

It is against this background that euro area governments have decided to establish a permanent crisis management mechanism, the ESM, as an ultima ratio safeguard against imbalances in individual countries.

An efficient official financing framework must be designed in a way that minimises moral hazard and reinforces incentives to undertake fiscal and macroeconomic adjustment and to seek market financing as soon as feasible. This can be achieved through strict conditionality and fair but non-concessional loan pricing provisions. The following section outlines the salient features of the ESM and compares them with the temporary crisis management arrangements currently in place.

2 FEATURES OF THE EUROPEAN STABILITY MECHANISM

THE BASIS FOR THE MECHANISM

At its meeting on 28-29 October 2010 the European Council agreed to establish a permanent crisis management mechanism to safeguard financial stability in the euro area as a whole, replacing temporary solutions such as the Greek loan facility, the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) from 1 July 2013. The EFSF will remain in place beyond June 2013 until all its outstanding claims have been repaid. Any tranches of existing loan facilities that remain undisbursed and unfunded at the time of entry into force of the ESM in July 2013 will be paid out under the new facility. In order to limit the potential liability of euro area countries during this transition period, total consolidated EFSF and ESM lending may not exceed €500 billion.

Political consensus on the ESM was reached at the meeting of the European Council on 16-17 December 2010, when it was agreed to add a new paragraph to Article 136 of the Treaty via the simplified revision procedure. Following opinions from the European Commission, the ECB and the European Parliament, the European Council adopted the following wording: "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."[5]

The wording of this new paragraph reflects some important preconditions for the establishment of a permanent stability mechanism.[6] In particular, the condition that the ESM can only be activated "if indispensable to safeguard the stability of the euro area as a whole" and the strict conditionality attached to assistance are necessary to limit the moral hazard implicit in a crisis management mechanism and to ensure that the existence of the ESM does not weaken incentives for sound fiscal and macroeconomic policies in euro area countries. The proposed amendment to Article 136 of the Treaty is planned to enter into force

5 See European Council Decision 2011/199/EU of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro.
6 See *Reinforcing economic governance in the euro area*, ECB, 10 June 2010.

Financial assistance facilities for euro area countries

	Euro area intergovernmental loans to Greece	European Financial Stabilisation Mechanism	European Financial Stability Facility	European Stability Mechanism
Legal/ institutional form	Intergovernmental agreement	EU mechanism	Private company owned by euro area countries	Intergovernmental organisation
Capital structure	None, bilateral loans pooled by the European Commission	Guaranteed by EU budget (i.e. all EU Member States)	Guarantees and over-guarantees from euro area countries	€80 billion paid-in capital and €620 billion callable capital (payment of initial shares by euro area countries to be made in five annual instalments of 20% of the total amount)
Lending capacity				
EU/euro area limit	€80 billion	€60 billion	€440 billion [1]	€500 billion
Commitments	€80 billion	€22.5 billion for Ireland	€17.7 billion for Ireland (plus €4.8 billion in bilateral loans)	N/A
		€26 billion for Portugal	€26 billion for Portugal	N/A
Instruments	Loans	Loans, credit lines	Loans, bond purchases on the primary market [1]	Loans, bond purchases on the primary market
Duration	Loans to be repaid seven and a half years after disbursement date in 22 equal quarterly payments	Until the end of June 2013	Until the end of June 2013. Will also remain operational thereafter until all outstanding liabilities are repaid	Permanent mechanism from the beginning of July 2013 onwards
ECB involvement	Involved in programme design and monitoring, and as paying agent	Involved in programme design and monitoring, and as paying agent	Involved in programme design and monitoring, and as paying agent	Involved in conducting debt sustainability analysis, programme design and monitoring, and as paying agent
Main decision-making bodies	Eurogroup	ECOFIN Council, acting by qualified majority voting on proposal from European Commission	Eurogroup/EFSF Board of Directors	Eurogroup/ESM Board of Governors and ESM Board of Directors
Legal basis				
Financing	Intergovernmental decision and Treaty Article 136	Treaty Article 122 (a Member State facing "exceptional occurrences beyond its control")	Intergovernmental decision	Intergovernmental treaty linked to amended Treaty Article 136
Conditionality	Treaty Articles 126 and 136	EU Council Decision on basis of EFSM Regulation	EFSF Framework Agreement by cross-reference with Memorandum of Understanding and EU Council Decision	EU Council Decision on basis of regulation under Treaty Article 136 (forthcoming)

1) After adoption of the amended EFSF Framework Agreement.

on 1 January 2013,[7] allowing the ESM to begin operations in July 2013.

THE GOVERNANCE OF THE EUROPEAN STABILITY MECHANISM

The ESM will be an intergovernmental institution established under public international law by a treaty signed by the euro area countries. The EFSF, by contrast, is a private company incorporated under Luxembourg law.

The most important decisions in relation to the ESM will be taken by its Board of Governors.

7 The amendment to Article 136 can only enter into force when notifications of ratification have been received from all EU Member States. If this is not the case before 1 January 2013, it will enter into force on the first day of the month following the receipt of the last of the notifications.

The Board of Governors will be made up of the finance ministers of the euro area countries, i.e. the members of the Eurogroup. The European Commissioner for Economic and Monetary Affairs and the President of the ECB will be observers. Decisions on, among others, four key issues will be taken by mutual agreement: the granting of financial assistance; the terms and conditions of financial assistance; the lending capacity of the ESM; and changes to the menu of instruments. "Mutual agreement" is defined as a decision taken unanimously by those countries participating in the vote, meaning that abstentions do not prevent the decision from being adopted. This will contribute to the decision-making efficiency of the ESM. All other decisions of the Board of Governors will be taken by qualified majority, which is defined as 80% of the weighted vote. Votes will be weighted in proportion to the countries' shares in the capital of the ESM.

A second decision-making body, the Board of Directors, will be responsible for specific tasks delegated by the Board of Governors. Each euro area country will appoint one Director and one alternate Director, with the European Commission and the ECB as observers. A Managing Director responsible for the day-to-day management of the ESM will chair the Board of Directors. The ESM will be based in Luxembourg, as is the EFSF. This will help ensure a smooth transition from the EFSF to the ESM.

The example of the programme for Ireland under the EFSF has shown that non-euro area EU Member States may wish to participate in providing financial assistance to euro area countries on an ad hoc basis. This possibility will be retained under the ESM. In such cases, the non-euro area Member States in question will be represented in relevant meetings of the ESM boards, have access to all relevant information and be appropriately consulted.

The ESM will cooperate very closely with the IMF in providing financial assistance. In all circumstances, the active participation of the IMF will be sought, at both a technical and a financial level. As further explained below, the IMF will be expected to play an important role in all phases of the activation and monitoring processes, in accordance with its own decision-making procedures and mandate.

The ECB will be involved in parts of ESM operations. First, it will liaise with the European Commission and the IMF to assess whether there is a risk to the financial stability of the euro area as a whole and undertake a rigorous debt sustainability analysis. Second, ECB staff will contribute technical expertise, where relevant, to the negotiation of a macroeconomic adjustment programme and the monitoring activities of the ESM.

THE INSTRUMENTS OF FINANCIAL ASSISTANCE

The ESM has been set up to provide financial assistance, subject to strict conditionality, to euro area countries experiencing severe financing difficulties. As with the EFSF, this assistance will predominantly take the form of loans, known as ESM stability support (ESS). ESS will be conditional on agreement to and compliance with a strict macroeconomic adjustment programme. The maturity of the ESS loans will depend on the nature of the imbalances and the beneficiary country's prospects of regaining access to financial markets. The interest rate on the loans, which may be either fixed or variable, will be the sum of the funding cost to the ESM and a charge of 200 basis points. An additional surcharge of 100 basis points will be added for amounts still outstanding after three years. The pricing policy will be reviewed by the ESM Board of Governors on a regular basis.

Should the Board of Governors decide to change the pricing structure and policy of the ESM, it will remain important that incentives are properly set, along the lines described below.

This pricing structure is in line with the principles governing the pricing of IMF financing and reflects an important principle for the provision of official financial assistance.

Interest rates should make financial assistance unattractive and minimise sources of moral hazard, implying a minimum level that is higher than the historical average rate charged by the markets under "normal conditions". This minimum level is also necessary to provide appropriate compensation for the risk taken by the members of the ESM.

As an exception, the ESM will have the option to purchase the bonds of a beneficiary euro area country in the primary market. In such cases, the ESM could, for example, act as a backstop facility, absorbing portions of primary offerings which are not taken up by private bidders. Such a strategy could potentially help the country concerned to regain access to market financing, thereby improving the cost-efficiency of the support. The conditions and modalities under which bond purchases would be conducted will be specified in the terms and conditions of financial assistance for the beneficiary country, but will in all cases be subject to the same macroeconomic conditionality as applied under ESS.

It is important for the ESM to have an appropriate range of instruments to preserve financial stability in the euro area as a whole. However, the fact that the ESM can also resort to primary market bond purchases as part of its overall programme strategy to support macroeconomic adjustment may be only a partial solution. As developments in the primary market in government bonds depend critically on developments in the secondary market (via the liquidity and price channels), the ESM should, in the longer term, also have the capacity to intervene in secondary government bond markets in order to effectively combat contagion in situations of acute market instability. The ESM Board of Governors will have the authority to decide by mutual agreement to expand the instruments available to the ESM. By contrast, any expansion of the instruments available to the EFSF requires an amendment to its Framework Agreement.

IMPLEMENTATION OF THE MECHANISM

ESM financial assistance will only be activated upon receipt by the Eurogroup and ECOFIN Presidents, and the Managing Director of the IMF, of a request from a euro area country. Following this request, the European Commission, together with the IMF and in liaison with the ECB, will assess whether there is a risk to the financial stability of the euro area as a whole and will undertake a rigorous analysis of the sustainability of the public debt of the requesting country. If, on the basis of the sustainability analysis, it is concluded that a macroeconomic adjustment programme can realistically restore the public debt to a sustainable path, the Commission, together with the IMF and in liaison with the ECB, will then assess the actual financing needs of the country concerned. On the basis of this assessment, the Board of Governors of the ESM will mandate the Commission, together with the IMF and in liaison with the ECB, to negotiate a macroeconomic adjustment programme, the details of which will be laid down in a Memorandum of Understanding (MoU). The MoU should be fully consistent with the overall EU framework for economic policy coordination. The Commission will propose to the EU Council a decision endorsing the macroeconomic adjustment programme, while the granting and the terms and conditions of financial assistance will be decided by the Board of Governors of the ESM.

The Commission, together with the IMF and in liaison with the ECB, will monitor compliance with the macroeconomic adjustment programme, reporting to the ECOFIN Council and the Board of Directors of the ESM. On the basis of this report, the Board of Directors will decide by mutual agreement on the disbursement of further tranches of the loan. After the completion of the macroeconomic adjustment programme, the EU Council may decide, on the basis of a proposal from the Commission, to implement post-programme surveillance,

which can be maintained for as long as a specified amount of the financial assistance has not been repaid.

As regards oversight, the ESM will be under the direct control of the euro area countries through the ESM Board of Governors. The European Parliament will also be reported to on a regular basis on the establishment and the operations of the ESM. Moreover, the ESM accounts will be subject to internal and external audits. The ESM will publish an annual report containing an audited statement of its accounts and circulate among the euro area countries a quarterly summary of its financial position and a profit and loss statement showing the results of its operations.

The rules and procedures that will govern the assessment and lending activities of the ESM reflect long-standing IMF practice. Accordingly, disbursements of financial assistance will be strictly conditional on the implementation of the macroeconomic adjustment programme. If a euro area country does not adhere to the programme, the Board of Directors of the ESM may decide to delay or suspend the disbursement of tranches. In such a case, the country would also lose the catalytic role that the existence and proper implementation of an adjustment programme would play in convincing the private sector to maintain its exposure. It is therefore in the best interests of the beneficiary country to adhere to the programme.

The prospect of official financial assistance being available under certain conditions can, of course, alter incentives related to the conduct of national economic policies and thus introduce moral hazard. It has already been noted that the institutional design of the ESM and the pricing structure of ESM loans are critical to containing this moral hazard. The same is true of the practical arrangements for the disbursement of official financial assistance. The EU authorities and the IMF therefore need rigorous analytical and policy procedures to assess the need for financial assistance and to monitor compliance with policy conditionality, while the beneficiary country must be steadfastly committed to the implementation of the macroeconomic adjustment. In the end, it will be crucial that all actors involved ensure that the programme is properly enforced in the country concerned.

PRIVATE SECTOR INVOLVEMENT

Where financial assistance is granted to a euro area country by the ESM, consideration will be given on a case-by-case basis to an adequate and proportionate form of private sector involvement in the closing of the financing gap. This will serve various purposes. Among other things, it should help to ensure an appropriate pricing of risk in government bond markets and fair and proportionate burden sharing between taxpayers and private creditors in the provision of the financial assistance. The nature and extent of this involvement will be determined case by case, in line with IMF practice (see Box 1). At the same time, the design of any private sector involvement should be such that it provides the utmost incentives for countries under stress to honour their obligations rather than consider default.

Where the debt sustainability assessment indicates that sustainability can be restored through a realistic macroeconomic adjustment programme, which is normally expected to be the case, the beneficiary country will be required to take initiatives aimed at encouraging the main private investors to maintain their exposures voluntarily.

Box 1

THE INTERNATIONAL MONETARY FUND'S APPROACH TO DEBT SUSTAINABILITY ASSESSMENTS, PRIVATE SECTOR INVOLVEMENT AND ITS PREFERRED CREDITOR STATUS

Given its mandate, the IMF needs to be able to provide financing to its members with a balance of payments need at times when international debt markets are unwilling to lend or will only do so at punitive interest rates. To this end, three key principles are applied to protect the Fund's financial position and to ensure that its support is repaid.

The first key principle underlying IMF lending is that the Fund can provide financing only when a member's debt is sustainable, taking into account the national authorities' adjustment programme. Therefore, a debt sustainability analysis is conducted to determine the member's capacity to service its debt without unduly large policy adjustments. Since 2002 the IMF has had a formal debt sustainability assessment framework in place. This framework consists of complementary analyses of the sustainability of the country's total public and total external debt. As debt sustainability cannot be interpreted in a mechanistic fashion, the results are assessed against country-specific circumstances, including the particular features of a country's debt, its policy track record and its policy space.[1]

The second key principle is that the adjustment programme needs to be fully financed (as IMF financing is generally only a fraction of total programme financing). A country's financing gap is closed by a combination of (i) domestic adjustment, (ii) external official support from the Fund and possibly from other official creditors, and (iii) private sector involvement. The mix of these elements is determined on a case-by-case basis, and will depend on judgments about the size of the country's financing gap, its capacity for economic adjustment, and the country's market access and debt sustainability prospects.

In most cases, a combination of policy adjustment and financing from both public and private sources is sufficient to preserve sovereign debt sustainability. The existence of a credible Fund-supported adjustment programme is assumed to play a catalytic role in this regard, by helping to convince private creditors to provide the necessary financing. In most cases, the involvement of the private sector therefore takes the form of maintaining exposure and/or providing additional financing on terms consistent with medium-term sustainability (either voluntarily or as a result of official moral suasion).

In exceptional cases, the IMF may come to the conclusion that debt sustainability cannot be achieved through policy adjustment. If so, the IMF is precluded from providing further financing without assurances that the country is negotiating a comprehensive debt restructuring plan with its private creditors. However, whether or not a debtor country undertakes sovereign debt restructuring is solely a decision for the country itself, not for the IMF or any other creditor. In these exceptional cases, the involvement of the private sector takes the form a debt restructuring that lowers the country's debt service payments through a prolongation of the repayment period, a reduction of interest or a reduction of the principal amount outstanding. In recognition of their potential role in facilitating the restructuring of international sovereign bonds in an orderly manner, the IMF supports the use of collective action clauses in international sovereign bond contracts.

1 *Staff Guidance Note on Debt Sustainability Analysis for Market Access Countries*, IMF, Washington D.C., July 2008.

The third key principle concerns the IMF's de facto preferred creditor status, which refers to the willingness of the Fund's debtor member countries to give priority to repayment of their obligations to the Fund over other creditors, and the agreement or acquiescence of other creditors to this situation. There is no explicit legal basis for such status. However, the concept is applied in the Paris Club, where official bilateral creditors have been willing to exclude the Fund from the restructuring process. Preferred creditor status is fundamental to the IMF's financing role. By reducing the risk on its lending activities, it bolsters the IMF's ability to provide financial assistance to its debtor members in cases where private creditors may not be willing to do so, while at the same time protecting the reserve assets that its creditor members have placed in the custody of the Fund. IMF debtor members have a long history of respecting the Fund's preferred creditor status, partly because keeping up with IMF repayments is key to unlocking additional financing or debt relief from other creditors, such as the Paris Club. The existence of a Fund-supported adjustment programme has often been considered essential by creditors (official and private alike) to providing assurance that the country in question would have the capacity to repay (restructured) debt over the medium term.

Where it is concluded that a macroeconomic adjustment programme cannot realistically restore the public debt to a sustainable path, the beneficiary country will be required to engage in active negotiations in good faith with its non-official creditors to secure their direct involvement in restoring debt sustainability. In this case, the granting of financial assistance will be contingent on the country having a credible plan for restoring debt sustainability and demonstrating sufficient commitment to ensure adequate and proportionate private sector involvement. If debt sustainability can be reached through these measures, the ESM may provide liquidity assistance.

In order to facilitate this process, from July 2013 standardised and identical collective action clauses (CACs) will be included, in such a way as to preserve market liquidity, in the terms and conditions of all new euro area government bonds with a maturity of above one year. These CACs will be consistent with those common under English and New York law since the G10 report on CACs, and will include aggregation clauses allowing all debt securities issued by a euro area country to be considered together in negotiations. This would enable the creditors to take a qualified majority decision agreeing a legally binding change to the terms of payment (standstill, extension of the maturity, interest rate cut and/or haircut) in the event that the debtor is unable to pay (see Box 2).

Box 2

COLLECTIVE ACTION CLAUSES FOR NEW EURO AREA GOVERNMENT BONDS

On 28 November 2010 the Eurogroup decided that collective action clauses (CACs) would be included in the international and domestic issues of euro area government securities (with a maturity of above one year) from July 2013 onwards. This decision was confirmed in the Conclusions of the Heads of State or Government of the euro area of 11 March 2011 and in the Conclusions of the European Council of 24-25 March 2011. CACs are contractual provisions inserted into the terms and conditions governing bonds. They have been used in sovereign bonds governed by English law for many years and, following the publication in 2002 of the Report of

the G10 Working Group on Contractual Clauses, they have also been developed by the private sector for use in sovereign bonds governed by New York law.

CACs are designed to ensure orderly sovereign debt restructuring. They provide an effective means for a supermajority of bondholders (66⅔% or 75%) and the debtor to restructure outstanding bonds (e.g. modify key payment terms, or convert or exchange bonds). Such restructuring usually applies to a single bond series, but it can also apply across multiple bond series using "aggregation clauses" (which are used by sovereign issuers such as Uruguay and Argentina). CACs imply that any restructuring modifications accepted by the specified majority of bondholders are conclusive and binding on all holders of the debt securities of a particular bond series – whether or not they have given their consent – which facilitates successful debt restructuring by overcoming the problem of "hold-out" creditors.[1] In order to deter disruptive litigation by minority bondholders resisting the restructuring, CACs may concentrate the power to initiate litigation in a single entity (e.g. a trustee), while making the power to declare bonds immediately due and redeemable at their principal amount together with accrued interest upon default dependent on a collective vote of the creditors, and providing for the ability to reverse such a declaration by a majority of creditors. CACs also aim to foster early dialogue and coordination between the sovereign and its creditors through the nomination of a permanent negotiating representative and the imposition of certain additional information-providing obligations upon the issuer.

It is envisaged that the main features of the CACs to be used in euro area government bonds will be consistent with those commonly used under New York and English law since the 2002 G10 report. CACs will be introduced in a standardised form, which will ensure that their legal impact is similar in all euro area jurisdictions, thereby preserving a level playing field among euro area countries.

The detailed legal arrangements for including CACs in euro area government securities will be decided on the basis of work being undertaken by the EU's Economic and Financial Committee Sub-Committee on EU Sovereign Debt Markets, following appropriate consultation with market participants and other stakeholders, and will be finalised by the end of 2011.

1 A "hold-out" situation occurs when some creditors hold back from accepting an exchange offer made by the issuer in an attempt to restructure outstanding bonds and try to retain the right to demand repayment of their bonds at par (the full nominal amount). It is argued that hold-outs pose a litigation threat to the sovereign borrower and may significantly undermine its ability to service the new bonds it has issued to the creditors participating in the exchange.

Without prejudice to these considerations, however, it is important to note that resorting to debt restructuring as a form of private sector involvement would be a very costly process, not only for the country concerned but also for other euro area countries. A restructuring of sovereign debt could significantly undermine the financial sector of the country concerned and would risk contagion to exposed banks in other euro area countries. As a recapitalisation of the exposed banks could become necessary to compensate for the losses on government bonds of the restructuring country in their portfolios, further strain could be put on the fiscal positions of the euro area governments concerned. Any debt restructuring is also likely to imply far-reaching second-round effects, in part through the increase in banks' holdings of non-performing loans extended to governments and non-financial corporations. Indirect contagion to other euro area countries via confidence effects is also possible. The high and unpredictable costs of any form of debt restructuring reinforce the need to ensure a very strict implementation of the new Stability and Growth Pact to eliminate the

risk of such debt restructuring being needed in the first place.

In line with IMF practice, the ESM will have preferred creditor status as of July 2013 (see Box 1), while recognising the preferred creditor status of IMF claims over ESM claims. However, if ESM financial assistance were to follow a European financial assistance programme existing at the time of the signature of the ESM Treaty, ESM loans would enjoy the same seniority as all other loans and obligations of the beneficiary country, with the exception of IMF loans.

THE FUNDING OF THE ESM

The ESM will have a total subscribed capital of €700 billion, of which €80 billion will be paid-in capital and €620 billion callable capital. This capital structure has been put in place to ensure the highest possible credit rating for the ESM, while also guaranteeing a lending capacity of €500 billion, the same as the combined lending capacity of the EFSM and EFSF.

Starting in July 2013, the paid-in capital will be provided in five equal annual instalments. The ESM will also finance itself through the issuance of debt securities. Euro area countries have made a commitment to ensure a minimum ratio of 15% between paid-in capital and outstanding ESM securities issuance during the period over which capital is paid in.

The design of the capital structure of the ESM should contribute to its robustness and set appropriate incentives for euro area countries. First, the paid-in capital makes the ESM less vulnerable to "migration risk" (i.e. the risk emanating from potential downgrades of the credit ratings of individual euro area countries) than the EFSF, meaning that sovereign credit ratings will play a lesser role in the overall rating of the ESM. Second, the use of callable capital in addition to guarantees allows greater flexibility. For example, the Board of Directors can decide by simple majority to call in capital if the paid-in capital is reduced through the absorption of losses. The immediate budgetary consequences of a decision to call in additional capital provide strong incentives to contributing euro area countries to approve the provision of financial assistance only if they (i) consider such assistance to be indispensable to safeguarding the financial stability of the euro area as a whole and (ii) are convinced that loans will indeed be paid back.

It should also be noted that the capital structure allows debt owed by the ESM to be classified as public debt of a "European institution" rather than of individual euro area countries (see Box 3 for more details). Nonetheless, as euro area countries are entering into commitments to provide additional finance through the ESM under specific circumstances, the contingent liabilities arising from these commitments must be carefully monitored.

Box 3

THE STATISTICAL TREATMENT OF THE EUROPEAN FINANCIAL STABILITY FACILITY AND THE EUROPEAN STABILITY MECHANISM

Following the decision by the European Council at its meeting on 16-17 December 2010 to establish a permanent stability mechanism, the European Commission (Eurostat) was asked to assess the statistical treatment of the ESM. Eurostat consulted the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB), which consists of senior statisticians from all EU national statistical institutes, national central banks, Eurostat and the ECB. On the

basis of the CMFB's opinion, Eurostat decided that the features of the ESM warrant different treatment to that of the EFSF, which the ESM will replace in mid-2013.[1]

Features and statistical treatment of the European Financial Stability Facility

The EFSF was set up to lend money to euro area countries in financial difficulties. Its borrowing is guaranteed by the other euro area countries. It was set up as a private company under Luxembourg law with very limited capital relative to its borrowing and lending capacities. Its main activities are determined by the Eurogroup.

As the EFSF is acting on behalf of the guarantor euro area countries when lending to a country in need, such a lending operation is routed through the government accounts of the guarantor countries. This means that for macroeconomic statistical purposes the money that a beneficiary country borrows from the EFSF is not recorded as a direct loan from the EFSF to that country but as a loan from the EFSF to the guarantor countries. These guarantor countries in turn lend the money to the country in need. This method of recording means that not only does the gross government debt of the country in need increase, but also the gross government debt of the guarantor countries in proportion to their respective shares in the guarantees provided to the EFSF.

In substance, the support operations of the EFSF are thereby treated in a similar way to the coordinated bilateral loans to Greece from the other euro area countries.

Features and statistical treatment of the European Stability Mechanism

The ESM has some envisaged features which will make it quite different from the EFSF. The ESM will not be a private company but a permanent international organisation, set up by a treaty signed by the euro area countries. Its governance structure will also be similar to that of other international organisations. Moreover, the ESM will have a substantial paid-in capital of €80 billion, implying a capability to bear risks on its own.

On the basis of these envisaged features, and following the CMFB's opinion, Eurostat decided that the ESM should be treated in the same way as similar international financial organisations such as the IMF. Loans from the ESM to a euro area country in need will be recorded in the same way as a loan from the IMF to a Member State (i.e. as a direct loan from an international organisation to the country in question). Therefore, unlike the loans provided by the EFSF, the loans provided by the ESM will not be routed through the accounts of other euro area countries and will therefore not increase their government debt.

1 The CMFB opinions and Eurostat decisions on the EFSF and the ESM are available on the CMFB's website (www.cmfb.org).

Euro area countries will contribute to the ESM's capital according to their share in the ECB's capital key, which gives equal weight to the country's shares in the total population and total GDP, respectively, of the EU. However, euro area countries that have a relatively low GDP per capita (i.e. below 75% of the EU average), will see their contribution reduced for a maximum period of 12 years after the entry into force of the ESM or after their entry into the euro area.[8]

8 This temporary correction will be as follows: ESM share = ECB key share - 0.75*(ECB key share - gross national income share).

3 CONCLUSIONS

Strengthened fiscal, macroeconomic and macro-prudential surveillance is essential to ensure the smooth functioning of EMU. Strict observance of the enhanced Stability and Growth Pact, close surveillance of macroeconomic imbalances and effective economic policy coordination should provide a safeguard against the build-up of systemic risks that might trigger crises of confidence of the type and magnitude that have been experienced in the recent past. However, to the extent that unforeseen external shocks can occur, the risk of crises can never be fully eliminated, in spite of strengthened fiscal and macroeconomic surveillance. For this reason, and in order to ensure the stability of the euro area as a whole, it was decided to also establish a framework which could provide temporary financial support to euro area countries, with the aim of providing bridge funding for the period of time needed to implement a deep adjustment programme to correct imbalances.

The establishment of a permanent crisis management mechanism for the euro area can thus support the overall structure of EMU. From the ECB´s perspective, it is crucial that the existence of the ESM, its design and its activities do not create moral hazard, but rather strengthen the incentives for prudent fiscal and economic policies in all euro area countries over the long term. For this reason, it is essential that any financial assistance will be subject to very strict macroeconomic policy conditionality and be granted on non-concessional terms.

Financial assistance must not act as a fiscal transfer, but only as a liquidity bridge that allows euro area countries in distress to take the necessary measures to “buy time” to restore fiscal sustainability and competitiveness in the medium term. The ESM would be activated only if indispensable to safeguard financial stability in the euro area as a whole. It is therefore of the utmost importance that the range of measures focusing on crisis prevention and policy surveillance are well-designed and implemented in full so that using the ESM does not become necessary.