

## THE ESM – WHAT IS BEHIND THE PROPOSITIONS?\*

The debt crisis revealed serious gaps in the hitherto economic management system of the European Union. First of all, the principles of the Stability and Growth Pact (SGP) turned out to be completely ineffective, since they did not prevent the European Union from getting into trouble as a result of irresponsible fiscal policy. Secondly, it became clear that the euro area had no instruments for management in a critical situation, which made it impossible to undertake relevant actions.

The EU commenced to look for an answer how to overcome the crisis. Special rescue funds were established to prevent the crisis from spreading all over Europe. However, the aid mechanism that was established is not deprived of certain defects, which in fact reduce its effectiveness as regards crisis management. An effective mechanism should be based on the three pillars (Kapoor, 2010): crisis prevention, crisis mitigation and crisis resolution. The European Stability Mechanism will not effectively meet its preventive role. Moreover, the fulfilment of the other two functions also arouses many doubts. In the author's opinion, the most important problem is the moral hazard, which is an integral element of the stability mechanism. It may lead to serious consequences for the stability of the euro area in the future, thus making crisis prevention impossible. Moreover, the very structure of the system has some defects which reduce the effectiveness of the aid in the event of occurrence of a crisis. They are related to the access of the stability fund to liquidity, i.e. the ability to gain capital on the market, which in turn directly affects the size and cost of the financial support granted to states in need.

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\* The article refers to the structure of the ESM that was announced by the EC (and the decision taken) and do not take into account any further developments.

The proposed aid system architecture is burdened with moral hazard, thus, paradoxically enough, the establishment of the stability system will not only fail to eliminate one of the main causes of the present debt crisis, but it will in fact aggravate the crisis. The moral hazard is connected, most of all, with the abandonment of the no-bailout clause, which was an integral part as regards the creation of the currency union<sup>1</sup>. Secondly, it is related to the reduction in reliability of the rules laid down by the European Union. Not only is it about non-compliance with the provisions of the SGP in the past, but it is also about the current experiences related to the very process of establishment of a rescue system, which has been very defective since the very beginning. Briefly speaking, by undertaking measures aimed to overcome the debt crisis the European Union undermined its credibility.

The introduction by the EU of transparent principles of conditionality of granting aid may mitigate the problem related to the moral hazard, but on condition of high reliability and quality of the decisions made. At present it seems that the only way to limit the problem of the moral hazard in the adopted structure of the aid system of the European Union is the presence of an international institution, i.e. the IMF<sup>2</sup>. Due to the moral hazard, the existence of the aid mechanism should not discourage countries from introducing structural reforms, restoring and maintaining a fiscal balance and increasing competitiveness, since in the long run it is in fact the only way to maintain macroeconomic stability (Arghyrou, Kontonikas, 2010; White, 2010).

The purpose of this article is to answer a question about the effectiveness of the aid system being established in the European Union. The article consists of three parts. Part One briefly characterises the existing aid system for states of the euro area. Part Two focuses on the issue of the moral hazard in the euro area as one of the main causes of the debt crisis in the EU. Part Three contains an analysis of the structure of the aid mechanism.

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<sup>1</sup> Article 125 of the TFEU.

<sup>2</sup> Or, more broadly, in theory, involvement of an external entity in enforcing the principles of conditionality.

## 1. AID PACKAGE IN THE EU AS A REPLY TO THE CRISIS. HISTORICAL OUTLINE.

In May 2010 the European Council made a decision to establish an aid programme for indebted countries<sup>3</sup>. The aid package announced then covered the amount of 750 billion Euros, which was six times more than the budget of the European Union for 2011, which totalled ca. 120 billion Euros, and two times more than the value of the government debt of Greece. When comparing the amount of the aid package with the accumulated deficit of the Member States of the euro area, one may observe that it was higher by more than 200 billion Euros (Table 1). The agreed aid package was to include the following facilities: (1) medium-term financial assistance for balances of payments increased by 60 billion Euros<sup>4</sup> from issue of bonds guaranteed by the EU budget and launched under the terms discussed with the IMF; (2) special loan fund, supported by guarantees of Member States of the euro area to the amount of 440 billion Euros; (3) taking into account the possibility of use of aid of the IMF to the amount of 220 billion Euros or 50% of the means launched as part of the above-mentioned loan fund.

Table 1

Deficit, public debt and GDP, selected counties in 2010

Country	Deficit (EUR bln)	Public debt (EUR bln)	GDP (EUR bln)
EU	784	9828	12 266
Eurozone	551	7836	9176
Greece	24	329	230
Ireland	50	148	154
Portugal	16	160	173
Spain	98	639	1063
Italy	71	1843	1549
Cyprus	1	11	18
PIIGS+CYP	260	3130	3187

Source: Eurostat.

<sup>3</sup> It was a reply to the extending crisis in Greece (more on this issue in Part 2).

<sup>4</sup> More than 30 billion Euros was left to be used from the earlier envelope.

After the announcement of the establishment of the aid package, two facilities were created. The first one is the European Financial Stability Facility (EFSF), whose activity was supported with guarantees of Member States of the euro area to the amount of 440 billion Euros (see the analysis below)<sup>5</sup>, of the temporary character, which was to function till 2013. The other facility is the European Financial Stabilisation Mechanism (EFSM), for the amount of 110 billion Euros, supported with guarantees of the EU budget. Apart from that, the IMF was to provide support to the total amount of 250 billion Euros. The measures undertaken were expensive but they did not allow to solve the debt problem. The problem persisted and many questions were left unanswered. Less than a year later, in March 2011, German Chancellor Angela Merkel was supported by the Council (including France) as regards the establishment of a stable rescue fund. On 27 March 2011 the European Council announced the establishment of the European Stability Mechanism (ESM), worth 700 billion Euros. It was to start its operations in the second half of 2012, and, eventually, to replace the present EFSF and EFSM<sup>6</sup>.

### 1.1. The European Financial Stability Mechanism based on the existing facility providing medium-term financial assistance for balances of payments

The loans given as part of the medium-term financial assistance for balances of payments were initially intended for Member States of the European Union (excluding Member States of the euro area) that had difficulties with balances of payments<sup>7</sup>. The facility was established under Council Regulation (EC) No. 332/2002<sup>8</sup> of 18 February 2002<sup>9</sup>. The amount of the aid that was then assumed as part of the facility totalled 12 billion Euros.

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<sup>5</sup> A year after its establishment the guarantee was extended to 780 billion Euros to increase the lending capacity to the initially assumed amount of 440 billion Euros (more – see the analysis presented below).

<sup>6</sup> According to the assumptions, the fund was to commence its activities in 2013.

<sup>7</sup> The EU agreed to grant a loan to Hungary in the amount of 6.5 billion Euros, to Latvia in the amount of 3.1 billion Euros, and to Romania in the amount of 5 billion Euros, which means that the envelope to be used at the time of the announcement of the rescue package totalled 35 billion Euros (without taking into account the increase).

<sup>8</sup> It replaced the hitherto aid facility, established under Council Regulation No. 1969/88.

<sup>9</sup> Regulation adopted on the basis of Articles 119 and 308 of the TEC (at present Articles 143 and 352 of the TFEU).

However, in December 2008 the deteriorating situation on international financial markets made the Council increase the envelope of funds from 12 to 25 billion Euros, and during the summit in March 2009 the amount was further doubled to the total of 50 billion Euros<sup>10</sup>.

In May 2010, under the Council's decision, the envelope was increased by 60 billion Euros (to the amount of 110 billion Euros), and all Member States were covered by the facility. The inclusion in the EFSM of Member States of the euro areas did not require consent of the national parliaments. So far 48.5 billion Euros out of the envelope of 60 billion Euros has been used, including 26 billion Euros spent on the aid for Portugal and 22.5 billion Euros on the aid for Ireland<sup>11</sup>.

The European Commission was given a right to obtain funds on the capital market and from financial institutions (Council Regulation (EU) No. 407/2010). Bonds issued by the EC have a guarantee of the EU budget and joint and several guarantees of all 27 Member States, thanks to which they are the most secure (AAA rating). Profitability of such securities may be maintained on the level close to the profitability of German bonds.

At the time of the establishment of this facility it was emphasised that the financing should only be provided from means obtained on the capital market (and from financial institutions) and not directly by Member States. A condition for granting a loan is the adoption by the country of the economic policy aimed to restore or ensure stability in the scope of the balance of payments. The decision of the Council whether or not to grant the financial aid is made by qualified majority of votes at the request of the Commission. After consultations with the ECB the Commission defines the conditions of the aid and monitors the progress made by the country as regards its fulfilment of the assumptions of the adjustment programme. The payment of further tranches is conditional upon the result of the review<sup>12</sup>.

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<sup>10</sup> What had an influence on the suggestion of the European Council to double the amount, apart from the financial crisis development, was negotiations conducted with Romania with regard to the loan in the amount of 5 billion Euros.

<sup>11</sup> Global Credit Portal, Standard & Poor's, EC and EFSF.

<sup>12</sup> The Court of Auditors is entitled to carry out in a beneficiary Member State all financial controls or audits as it considers necessary in connection with aid management (Article 8 of the Regulation).

## 1.2. Aid as part of the new facility – EFSF

In June 2010 Member States of the euro area (in accordance with the Ecofin Council's applications of 9–10 May 2010) established the European Financial Stability Facility<sup>13</sup>. The EFSF was given a right to grant loans to indebted states, for the purpose of maintaining financial stability of the euro area. Funds are obtained from issue of bonds. Issue of the debt is supported with guarantees of Member States of the euro area in the amount proportional to their share in the capital of the ECB, in accordance with table 2<sup>14</sup>. It is Germany and France that give the largest guarantees. Sureties granted by these two states constitute almost 50% of the available amount.

Table 2

### Guarantee within the EFSF (for the moment of EFSF establishment)

Country	Share of EBC equity (%)	(EUR bln)
Germany	27.13	119.4
France	20.38	89.7
Italy	17.91	78.8
Spain	11.90	52.4
Netherlands	5.71	25.1
Belgium	3.48	15.3
Greece	2.82	12.4
Austria	2.78	12.2
Portugal	2.51	11.0
Finland	1.80	7.9
Ireland	1.59	7.0
Slovakia	0.99	4.4
Slovenia	0.47	2.1
Luxemburg	0.25	1.1
Cyprus	0.20	0.9
Malta	0.09	0.4
<b>All</b>	<b>100.00</b>	<b>440.0</b>

Source: own calculations. Share equity based on Annual Report EBC, 2009.

<sup>13</sup> In the form of a limited liability company under the law of Luxembourg.

<sup>14</sup> At the time of the establishment of the mechanism.

It was assumed that debt securities issued by the EFSF will get the highest rating. To obtain and maintain AAA rating, a structure was adopted in which countries guarantee 120% of the debt issued.

A loan may be granted provided that the countries meet the conditions of the remedy they were presented. Decisions on the terms of aid (tenor, cost and amount of the loan) are made by Ministers of Finance of countries participating in the mechanism.

### 1.3. European Stability Mechanism – ESM

On 27 March 2011 the European Council announced the establishment of the European Stability Mechanism. The ESM was established on the basis of extended Article 136 of the TFEU. It assumes a possibility to create a stable mechanism of providing financial assistance and support to countries, aimed to maintain stability of the euro area. Similarly to the EFSF, the fund's financing will be based on debt issuance supported with guarantees of particular countries, without joint and several liability. What is the most important element of the suggested structure is the inflow of cash into the mechanism. The value of the ESM reaches 700 billion Euros, including guarantees in the amount of 620 billion Euros and the capital paid in the amount of 80 billion Euros, as well as the undertaking to maintain the capital above 15% of the value of the issued debt. It was assumed that the adopted structure would allow to provide factual aid on the level of 500 billion Euros. Furthermore, in particular cases the involvement of creditors from the private sector was approved, and collective action clauses (CAC) were introduced<sup>15</sup> to new issued bonds, making it possible to involve private investors in the debt restructuring. It is important in the event that the debt issued by the ESM is subordinated to claims of the IMF.

Similarly to the EFSF, prior to the use of the assistance, the borrowing country must accept the conditions of the loan. Decisions on the launch of the aid are made by the Executive Board, comprising Ministers of Finance of particular countries.

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<sup>15</sup> See comment below.

## 2. PROBLEM RELATED TO MORAL HAZARD

### 2.1. Moral hazard as the cause of the crisis in the EU

The functioning of the aid mechanism is of great significance to the future financial stability of the European Union. Its structure creates a moral hazard<sup>16</sup> and generates many doubts as regards the potential for efficient overcoming of the existing debt problems. What has to be emphasised here is that the moral hazard is the phenomenon that often accompanies aid programmes granted by international organisations<sup>17</sup> (Dreher, Vaubel, 2004; Dreher, 2005)<sup>18</sup>. The moral hazard consists in taking additional risk by market participants, who assume that they are insured against risk (De Grauwe, 2011). Easy availability of loans may be interpreted as a subsidised insurance of revenues as a result of occurrence of a negative event (Vaubel, 1983). This situation directly affects the behaviour of insurance beneficiaries, i.e. Member States (direct moral hazard). The behaviour of the states may depend, to a certain extent, on the behaviour of creditors, i.e. foreign investors. In such a case we deal with indirect moral hazard. This is the case in the event of the adoption of the bail-out clause. It reduces the amount of the risk premium required by creditors, which in turn encourages the states to increase their debt.

As regards the EFSF/ESM<sup>19</sup>, we deal with both direct and indirect moral hazard. An easy access to cheaper financing will make states more inclined to conduct irresponsible fiscal policy in the future. It is completely justified when countries do not bear full liability for their actions. Governments of particular countries may be particularly encouraged to increase the government budget balance by funding, for a short term, a comfortable life at the future cost of the EFSF/ESM<sup>20</sup>. In turn, the abandonment by the EU from the no-bailout

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<sup>16</sup> In the opinion issued on 17 March 2011, the ECB pointed to the necessity to solve the problem related to the moral hazard.

<sup>17</sup> The research done relates to programmes implemented by the IMF. The issue of the moral hazard depends on the size of the aid programme. Nunnenkamp (1999), Lane and Phillips (2000) present the IMF as an example to indicate that in the event of smaller funds, they do not have to contribute to a significant increase in the moral hazard.

<sup>18</sup> The moral hazard increases with the increase in the amount of the aid granted as part of the aid programme (Dreher, Vaubel, 2004).

<sup>19</sup> The structure and assumptions of the EFSF and the ESM are similar to a large extent.

<sup>20</sup> What should be emphasised here is that the permission for the fund's intervention on the secondary market additionally poses a serious hazard that the fund will become a source of cheap money.

clause will affect a reduction in the risk premium required for the financing granted. As empirical research indicates, the insurance related to the bailout clause adversely affects the quality of the politics of the countries applying for aid (Dreher, 2004).

The bailout clause constitutes a significant source of the increase in the moral hazard (McKinnon i Pill, 1998; Frankel, 1998, Evrensel, 2002; Gai, Taylor, 2004). Arguments confirming the above statement may be found in the history of the policy of reacting to financial crises pursued by the IMF. As McKinnon (1998) and Frankel (1998) prove, the bail-out clause used in the case of Mexico in 1995 lead to the moral hazard and excessive adoption of risk by foreign investors, which became one of the main causes of the financial crisis in Asia in 1997. In turn, the inability of the IMF to prevent negative effects of the financial crisis in Russia in 1998 contributed to a reduction in the moral hazard (Dell’Ariccia, Schnabel, Zettelmeyer, 2002). It is worth noting that in the past of the aid programmes implemented by the IMF not all creditors managed to avoid loss. A lack of complete predictability of the results of the aid of the IMF does not eliminate, to the full extent, the risk of loss and, consequently, limits the moral hazard (Chang, 2000).

In the EFSF/ESM the moral hazard is closely related to the manner of making decisions and reliability thereof<sup>21</sup>. As the research shows, moral hazard may be particularly noticeable in the event of political pressure or influence on the decisions related to the financial aid granted (Krugman, 1998; Frankel, 1998). As regards the EFSF/EMS, the financial assistance is granted on an individual basis. To receive a loan, the state has to meet particular conditions and cooperate closely with the IMF, but the ultimate decision depends on the countries, though. It is the Executive Board of the IMF, comprising Ministers of Finance, that gives consent to grant a loan and decides on the amount of the costs related to the loan.

The moral hazard may be reduced by introducing transparent principles of granting financial aid (conditionality)<sup>22</sup>. Making the financial aid conditional on the fulfilment of particular conditions prevents countries from abuses (Bruce and Waldman, 1991; Vaubel, 1991) and significantly affects their determination to carry out necessary reforms. Sachs (1989) points out that on the one hand the introduction of conditionality for the financial aid provision contributes to an increase in acceptance for implementing necessary reforms, and on the other hand, it constitutes significant assistance in getting out of

<sup>21</sup> More: read below.

<sup>22</sup> In the further part of the text the term ‘conditionality’ is used.

the debt trap. Conditionality may also limit the problem of negative selection. The necessity for the countries to meet their obligations will result in reducing the number of borrowers to the states that really need the financial support (Nichols, Zeckhauser, 1982). Additionally, conditionality positively affects the manner of spending the means received as part of the aid programme (Little, Clifford, 1965)<sup>23</sup>.

What should be highlighted here is that the conditionality being a part of the aid provision mechanism, aimed to provide effectiveness, should be reliable and done *ex-ante*. The reliability in the creation of the programme, which has to be fulfilled prior to the provision of aid, seems to be particularly important and may significantly affect the determination of the countries to introduce reforms. That is why political influences at the stage of the definition of conditionality reduce the effectiveness of conditionality (Goldstein, 2000; Dreher, 2004; Dreher, Jensen, 2007). In the event of an *ex-post* research, a factor determining effectiveness of the conditionality is its enforceability<sup>24</sup>.

Politicising the decisions on the provision of aid by the EFSF/ESM makes the problem of quality and reliability unsolved. The prerequisite of the effectiveness of the conditionality is not met. Taking into account the present structure of the aid mechanism and a lack of reliability of the decision-making process in the EU<sup>25</sup> it seems that the only way to limit the moral hazard is the involvement of the IMF in the process related to granting the financing.

In the recent years one might observe that the IMF has been paying more and more attention to conditionality when granting financial support (Dreher, 2009). It should be mentioned that as regards economists conducting research related to the evaluation of effectiveness and effects of the use of conditionality by the IMF, words of criticism are also uttered.

One of the main critical arguments shows an increase in dependency of developing countries on money of the IMF (IFIAC, 2000, Vreeland, 2003). It is argued that the conditions of granting aid are aimed to achieve an internal balance without regard to the policy aimed at development of the countries (Payer, 1974; Dell, 1982). As Feldstein (1998) states, the use of too strict conditions of the provision of aid discourages countries from using the support, which in fact strengthens negative consequences of the crisis. When setting the conditions of the provision of the support in many cases

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<sup>23</sup> Most researches relate to conditionality imposed by the IMF.

<sup>24</sup> More on enforceability of the conditions imposed by the IMF in Beveridge, Kelly (1980), Haggard (1985), Edwards (1989), Dreher (2006) and others. The issue of enforceability of the fulfilment of the conditions relates to *ex-post* assessment.

<sup>25</sup> More on reliability of activities of the EU – see part 3.

the political situation of the country applying for the aid is not taken into account (Dreher, Vaubel, 2004), which in turn may make governments less inclined to meet the conditions imposed on them. It is the government's determination that is one of the most important elements as regards the effective implementation of desirable changes and fulfilment of the conditions imposed (Boughton, 2000; Paloni i Zanardi, 2004; Bird and Willett, 2004). The conditionality based on the introduction of structural changes is also criticised (Radelet, Sachs, 1998), since at the time when the country tackles the crisis, it takes a lot of time, political capital and distracts from attempts to mitigate the effects of the crisis<sup>26</sup>. Impossibility or difficulty in enforcing the fulfilment of the terms of the aid provided reduces the effectiveness of conditionality<sup>27</sup>. In such an event, the enforceability of the fulfilment of the conditions may be improved as a result of introduction of sanctions (Killick, 2006; Vreeland, 2006, 2007).

The impossibility to solve the problem related to the moral hazard does not only make it impossible to meet the prevention function of the stability mechanism, but it is against the maintenance of stability of the system in the EU. The moral hazard, which leads to an excessive increase in risk, is a source of financial crises. It is argued that the moral hazard was one of the main causes of the debt crisis in the EU (Dowd, 2009).

## 2.2. Moral hazard as the cause of the crisis in Greece.

### Historical approach

The Greek economy is a perfect example of the moral hazard and the free-rider effect, which are the two phenomena observed after the establishment of the Monetary Union (Sinn, 2010; Stolarczyk, Wojtas, 2011).

The European Union has been dealing with the debt crisis for more than 2 years. In May 2010 Greece revealed the factual condition of its public finance to Europe, which surprised financial markets and leaders of the Member States. It was the time when the conclusion that the country is on the verge of a financial disaster was the right one. The condition of the public

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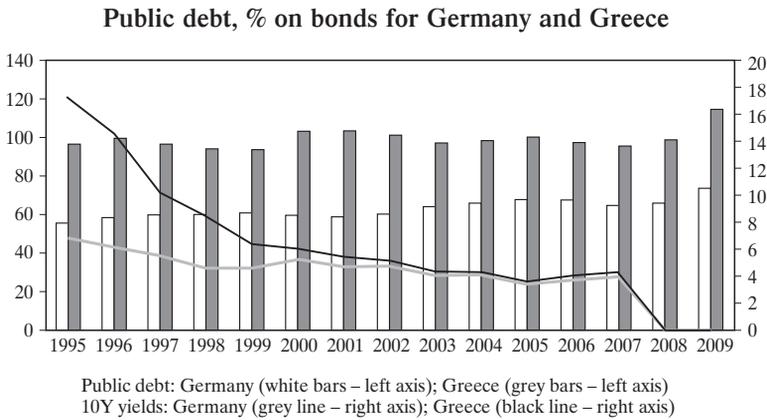
<sup>26</sup> Another issue that is frequently criticised is the very content of adjustment programmes implemented by the IMF (Dreher, 2009; Spraos, 1986; Bird, 2001). There are also a lot of researches that confirm a positive influence of aid programmes implemented by the IMF (Mercer-Blackman and Unigovskaya (2004), Nsouli (2004), Dreher (2009).

<sup>27</sup> Regards ex-post conditionality.

finance presented by Greece was a result of many years of negligence and cumulated irregularities.

The accession of Greece to the euro area significantly increased its reliability in the eyes of international financial markets, which, in turn, materially affected the price at which Greece was able to borrow money. The scale of this phenomenon is presented in Graph 1. The profitability of Greek bonds was close to the price of German bonds, despite a much worse condition of the public finance in Greece.

Graph 1



Source: own calculations.

The moral hazard that the Greek government dealt with consisted in burdening the budget with excessive debt, over the level which would be justified by real possibilities of the country’s economy. It was possible thanks to the ‘borrowing’ of credibility from larger and more stable economies, such as France or Germany. It is also worth mentioning, taking Greece as an example, that by lending Greece money at a price comparable to Germany the financial markets considered that the no-bailout clause referred to in the EU Treaties (Article 125 of the TFEU) is not reliable, and the rules defined in the SGP are completely ineffective<sup>28</sup>.

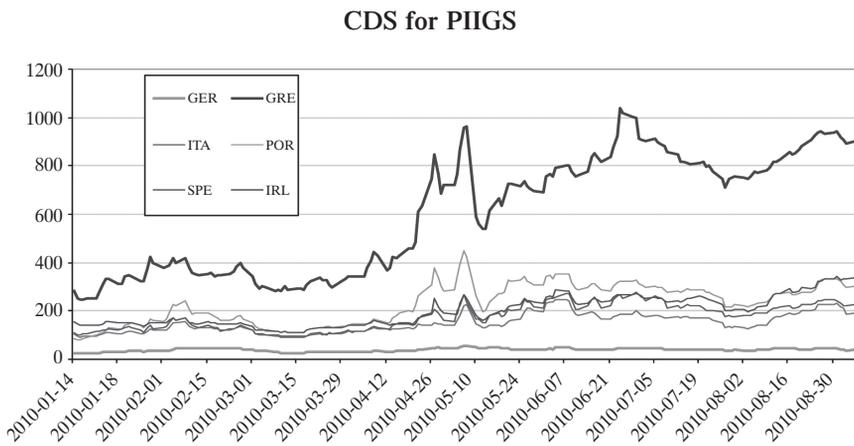
After the real financial situation of Greece had been revealed, its creditors started to perceive it as less and less credible. A race against the time began. Economists and economic politicians competed coming up with ideas on

<sup>28</sup> More: P. Stolarczyk, W. Wojtas, *Czy po konsumpcji „sześciopaku” UE czeka ból głowy?*, analizy FOR, X 2011.

how to solve the problem of the Greek debt. However, because of a lack of concrete decisions of the European Union and the fact that the Union only spoke about the support, the financial markets were not calmed down.

At the beginning of May 2010 the CDS values for Greece reached almost 1000 basis points, i.e. 974 points more than in case of Germany. In other words, investors perceived the risk of the bankruptcy of Greece as more than 30 times higher than in case of Germany and more than 4 times higher than in case of Ireland and Portugal (Graph 2). At the end of April the amount of the 10-year bid–offer spread of Greek bonds to German bonds, which reflected the risk of investments in Greece, exceeded 960 basis points, which was the highest level since the establishment of the common currency. Investors found that Greece had moved from the system of fully reliable countries supported by the euro area to the system of countries that are not provided with financial support by other Member States of the euro area (Arghyrou, Kontonikas, 2010). Greece was on the verge of bankruptcy.

Graph 2



Source: based on Bloomberg.

To calm down the financial markets, in May 2010 the European Council made a decision to establish an aid programme for indebted countries. On the one hand it put an end to the period of a lack of decisions of the EU officials, on the other hand, though, there was a change of the paradigm being the basis of the economic and currency union, in which every country is solely responsible for the condition of its public finance, and the budgetary discipline is not supervised as part of the criteria of convergence and the

Stability and Growth Pact. The notification of the abandonment of the no-bailout clause contributed to a significant reduction in the level of the Greek CDS. This may be interpreted as an increase in the moral hazard as a result of wrong perception of risk by investors connected with the insurance promise.

The establishment of the aid package calmed down the financial markets only for a short time. The following months showed clearly that Greece had no chance to restore the investors' confidence (in the months following the announcement of the decision the CDS values beat records again – Graph 2).

### 3. EVALUATION OF THE EXISTING AID SYSTEM

The Greek crisis shows that investors do not trust the rules and decisions made by the European officials. Further actions aimed to solve the crisis additionally reduced the reliability of the European Union. First of all, when making a decision on establishing the aid package the European Union undertook measures that are beyond its competences. Secondly, taking into account the structure of the stability mechanism, it was, from the very beginning, not enough to solve the problems of indebted countries.

#### 3.1. Acting beyond law

The EFSM was established under Council Regulation (EU) No. 407/2010 of 11 May 2010. The legal basis for the establishment of the EFSM is the content of Article 122(2) of the TFEU, which allows for the provision of financial aid by the Union to a Member State that 'is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control'. The adopted legal bases may be compared with Article 125 of the TFEU, which explicitly states that the commitments of a Member State (central governments, regional, local authorities, institutions or public enterprises) may not be assumed by another Member State or the Union as a whole.

The Treaty clearly points to the 'exceptional occurrences' beyond the control of the country as exceptions allowing for the provision of the aid by the EU. It was also presented clearly in Article 1 of Council Regulation (EU) No. 407/2010 establishing the EFSM.

On the one hand, the EFSM was established as a reaction to the 'exceptional occurrences', i.e. the international financial crisis, on the other hand, though,

the fiscal policy, carried out inefficiently, dependent directly on the authorities of the given country and ongoing decisions is beyond the content of Article 122(2) of the TFEU. In view of the above any attempts to launch aid for Greek authorities, solely responsible for excessive indebtedness and putting the country on the verge of bankruptcy, must raise serious questions on its justification under the afore-mentioned Article 122. The excessive debt of the country, which clearly stems from the authorities' conscious policy, may not be treated as 'exceptional occurrences'.

The decision of the EU has also led to far-reaching consequences. Apart from the requirements of the SGP, it was also the no-bailout clause defined in the Treaties (Article 125 of the TFEU) that was of fundamental significance for the limitation of the moral hazard in the euro area. By acting against this clause, the Union destroyed the credibility of its own principles<sup>29</sup>.

### 3.2. Evaluation of effectiveness of overcoming problems of indebted countries

The evaluation of effectiveness of the fund as regards the crisis solving is made, first of all, from the perspective of profitability of issued bonds on the market, which is reflected in the costs of loans given, and, secondly, from the perspective of the loan potential as compared with the needs of the indebted countries. The fund has been operating for a short time, which makes it impossible to evaluate the effects of the aid programme implemented in particular countries, which is why this issue will be omitted in the article.

What has to be pointed out is that the adopted assumptions related to the costs of obtainment of the capital as part of the EFSF have been difficult to obtain since the very beginning. It was assumed that the debt issued as part of the EFSF would be rated on the level of AAA and its profitability would be close to the profitability of German bonds.

It is noteworthy that taking into account the adopted structure of the guarantee on the level of 440 billion Euros, the real ability of the EFSF to obtain the financing was in fact much lower from the very beginning. It stems from the fact that bonds issued by the fund must be rated as AAA. At the time of the announcement of the rescue fund only six countries were rated on AAA level. The guarantees of the most stable countries totalled at that time

<sup>29</sup> At the same time the European Union carried out activities aimed to improve enforceability and effectiveness of the principles defined in the SGP by adopting a package of legal regulations, the so-called 'six-pack' and activities aimed to depreciate the no-bailout clause.

255 billion Euros (out of 440 billion Euros). To provide additional guarantees for the financial solutions, a capital buffer was established, to be maintained in cash or securities (for covering any potential loss), which was to facilitate increasing the issue security level to the maximum possible level. According to the adopted structure, the countries guarantee up to 120% of debt, which means that their responsibility for the issued debt exceeds the value of the debt by 20%.

Table 3 presents the rating level that might be obtained if the mechanism was based only on guarantees granted<sup>30</sup>.

Table 3

Estimated rating and bonds yields based on table 2 (for the 24<sup>th</sup> of August 2010)

Country/ rating	5Y yields	Share in guarantees	S&P	Fitch	Moody's
Germany	1.23	27.13	AAA	AAA	Aaa
France	1.56	20.38	AAA	AAA	Aaa
Italy	2.59	17.91	A+	AA-	Aa2
Spain	2.84	11.90	AA	AA+	Aaa
Netherlands	1.31	5.71	AAA	AAA	Aaa
Belgium	2.09	3.48	AA+	AA+	Aa1
Greece	11.64	2.82	BB+	BBB-	Ba1
Austria	1.67	2.78	AAA	AAA	Aaa
Portugal	3.88	2.51	A-	AA-	A1
Finland	1.44	1.80	AAA	AAA	Aaa
Ireland	4.31	1.59	AA	AA-	Aa2
Slovakia*	2.98	0.99	A+	A+	A1
Slovenia*	2.34	0.47	AA	AA	Aa2
Luxemburg	N/A	0.25	AAA	AAA	Aaa
Cyprus*	3.37	0.20	A+	AA-	Aa3
Malta	N/A	0.09	A	A+	A1
<b>SPV 5Y</b>		<b>2.21</b>	<b>AA/AA+</b>	<b>AA+</b>	<b>Aa1</b>
<b>Spread GER 5Y</b>		<b>0.98</b>			
<b>Spread GRE 5Y</b>		<b>9.43</b>			

\* data 3.09.2010

Source: own calculations.

<sup>30</sup> At the time of the announcement of the establishment of the fund.

The value of the real aid for countries as part of the package was lower from the time of announcement of the establishment of the fund than the ability to obtain the funding for the fund itself. It stems from the structure of the debt issued by the EFSF, in which some means are kept as a guarantee of the highest rating.

As it stems from the issue of bonds carried out so far as part of the aid programme for Ireland and Portugal, in order to keep AAA rating, 30% of the means obtained from the issue is kept as a guarantee of the highest investment rate<sup>31</sup>, and the other 70% is given to the country in the form of a loan.

Table 4 presents estimation of the total real aid for countries, including the means of the IMF at the time of the announcement of the aid package by the Union. The following assumptions were adopted for the estimates. The amount of the potential financing by the IMF was based on the amount of the aid granted to Greece, which reached 30 times more than its share in the capital of the IMF<sup>32</sup>. The share of the financing by the EU and the IMF reaches 2/3 and 1/3, respectively, for the borrowing needs of the given country, in compliance with the assumptions of the functioning of the aid mechanism.

The means available to the countries were estimated in the two options. Option 1 assumes the fund's lending capacity on the level of 440 billion Euros<sup>33</sup>. Option 2 assumes that the possibility to issue debt reaches 440 billion Euros, and the calculation of factual lending capacity was based on three issues of bonds by the EFSF for Portugal and Ireland.

As it stems from the estimates, in both options the borrowing needs of the PIIGS by 2013 considerably exceeded the envelope of available funds. The lending capacities reached 750 billion Euros for the first option, and 588 billion Euros for the second option.

The above analysis indicates that at the time of the announcement of the aid programme there were no prerequisites to assume that the amount of the aid would solve the hitherto problems of the most indebted countries. When taking into account the amounts of the aid as part of the future stability mechanism (700 billion Euros) and as part of the increased means of the IMF, in view of the problems of Spain and Italy, it should be remembered that the aid is still highly insufficient.

<sup>31</sup> It regards the first issues of the EFSF, aimed to provide aid.

<sup>32</sup> In accordance with: *Greece: Staff Report on Request for Stand-By Arrangement, IMF Country Report No. 10/110, May 2010.*

<sup>33</sup> In compliance with the information of 11 March 2011 on recapitalisation of the fund or increase in the guarantee level to a level ensuring creditworthiness on the level of 440 billion Euros.

Table 4

## Needs vs. help for PIIGS

Country	Share IMF in equity (SDR bln)	Share in IMF equity (EUR M. EUR//SDR 1.19 SDR)	IMF's lending	EFSF's lending	Lending Together	Borrowing needs till 2012*	Borrowing needs till 2013*	Borrowing needs till 2015*
Greece	0.82	0.98	29.38	58.76	88.14	94	135.7	258.4
Portugal	0.87	1.03	30.99	61.98	92.96	52.1	73.9	122.8
Ireland	0.84	1.00	29.99	59.98	89.96	41.3	59.3	87.3
Spain	3.05	3.63	108.89	217.77	326.66	325.2	457.5	679.4
Italy	7.05	8.39	251.69	503.37	755.06	558.4	757.3	1111.4
Cap for EFSF			220.00	440.00	720.00	1071.0	1483.7	2259.3
EMSF					60.00			
Borrowing needs of GRE. POR. IRL						187.4	268.9	468.5
Lending capacity based on firs programmes			220	308**	588			

\* debt service and projected deficits

\*\* based on programmes issued

Source: own calculations based on IMF Bloomberg.

The future amount of the means available as part of the aid may turn out to be much lower than the amounts announced at present, if the fund tries to keep the lowest capital cost (AAA rating of issued bonds).

In the adopted structure there is a risk of increase in the cost of obtainment of financial means by the EFSF/ESM as a result of a reduction in the degree of the security of the issued debt, i.e. loss of a possibility of issuing AAA securities. First of all, at the time of the establishment of the mechanism there were only 6 countries-guarantors that were given the highest rating (AAA)<sup>34</sup>. Deterioration of the situation of one of these countries creates pressure on an increase in yield of the debt issued, or results in a significant

<sup>34</sup> Recently the rating of France and Austria was lowered.

reduction in the lending capacity<sup>35</sup>. Secondly, the problems of the most indebted countries, i.e. potential borrowers, may reduce the stability of the most reliable countries. It stems from high exposure, i.e. potential loss, of such countries as Germany or France to the risk of bankruptcy of the most indebted economies, e.g., Greece (OECD, 2010). Apart from that, there is also a problem related to the very time of the issue of bonds by the EFSF. The issue is conducted at an explicit application of the country concerned, and the application is submitted when the country loses a possibility of financing on the market<sup>36</sup>. Larger and larger envelope of means allocated to risky loans will increase the risk of the operation of the EFSF/ESM. Next tranches of the aid may result in deterioration of the financial situation of the lenders (to the value of their guarantees), thus, posing a risk of reduction in the rating of these countries and the entire euro area. For example, 100 billion Euros of additional aid, e.g. for Greece, causes an additional off-balance financial liability of Spain in the amount of 12 billion Euros, and in the event of Italy, in the amount of 18 billion Euros. By rescuing the weakest countries we may contribute to the deterioration of the situation of the other countries.

Each case of the reduction in the rating of a large country will affect the fund's ability to contract debt on the assumed conditions. In other words, as a result of a reduction in the rating of the issue security, the fund would lose access to a cheap source of money in the expected amount. The above-mentioned ability to issue debt (and the fund's lending capacity related to it) with the simultaneous maintenance of the highest rating, i.e. bond profitability, on a reasonable and acceptable level, is possible but it requires recapitalisation of the fund (or an increase in the level of guarantee of the most reliable countries), to which the guarantors' consent is necessary. The situation is characterised by high political risk. The decision-making process may be extended due to (inter alia) political events taking place in particular countries (see example of Finland below). It is also impossible to exclude the possibility of a complete failure of the talks of the Union officials. It should not be surprising, since any form of the fund recapitalisation will increase the potential loss incurred by the countries-guarantors in the event of insolvency of the debtor. The investors' fears as regards the possibility to quickly work out an efficient solution of the problems of the most indebted countries

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<sup>35</sup> After the reduction in the rating of France in January 2012, the EFSF was reduced (S&P).

<sup>36</sup> It will considerably limit the access of the fund to liquidity.

may result in an increase in the debt service costs<sup>37</sup>. Another thing worth mentioning here is that bonds subscribed for by private investors will be in fact debt subordinated to the claims of the IMF. In this event investors may require an additional risk premium. The IMF does not establish convincing legal framework regulating the country's bankruptcy. From January 2013 Collective Action Clauses (CAC) will be included in the issued bonds. Thus, some time must pass before they constitute a significant share in the entire debt issued. The Collective Action Clauses, used in rescue programmes implemented by the IMF for emerging economies and developing countries make it easier for the given country to make arrangements with creditors from the private sector.

Moreover, countries granted the aid may be released from the guarantee obligation (in case of the EFSF it requires unanimous consent of participating countries and does not release the country from any other securities and guarantees granted by it before). In May 2010 it was established that Greece would not participate in guarantees for the EFSF. This decision resulted in a reduction in the level of the guarantees to 428 billion Euros. In the autumn of 2010 Ireland was released from the guarantee obligation, as a result of which the total of maximum guarantees was reduced to 421 billion Euros. If, after granting aid to Portugal, Spain joined the group of borrowers, the guarantees would be reduced to 357 billion Euros. What is more, in case of the EFSF even when assuming the unchanged amount of the guarantee on the level of 440 billion Euros, the fund's capacity to obtain financing reached ca. 365 billion Euros ( $440 \div 1.2$ ). It results from the adopted facility structure, in which countries guaranteed up to 120% of the debt (Fitch).

Another thing that should be pointed out is a high political risk related to the process of granting aid. It is the Council that makes decisions on granting aid, which means that the launch of a loan depends on political processes taking place in particular countries. Thus, a question arises about the quality of the decision and effectiveness of the aid mechanism. One might easily imagine a situation when the launch of the support is suspended due to the limitations resulting from the balance of power in the internal politics. What can well illustrate the above-mentioned phenomenon is the events that took place in Finland at the time of making a decision on aid for Portugal. The Finnish government postponed supporting the rescue package for Portugal,

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<sup>37</sup> After a time-consuming arrangement process the countries made a decision to increase the effective lending capacity of the fund to the amount of 440 billion Euros, which required increasing the guarantees to 780 billion Euros.

as it was afraid of the increasing popularity of the Eurosceptical Finns Party, which announced its plans to block the decision. The delay in the action and uncertainty about the result of the decision-making process when a country asks for aid, which in fact happens if the indebted country is no longer able to serve the debt, may turn out to be very expensive in the future.

## CONCLUSIONS

The removal of the defects indicated above and clarification of the doubts shown will determine the effectiveness of the aid mechanisms established in the EU, and, in the long term, the macro-economic stability of the entire Union. We are at an important point of the history of the economic integration, at the time of making decisions whose consequences will be faced for many years to follow. Leaving the problem of the moral hazard unsolved poses high risk for the future stability of the EU. The history teaches us that the introduction of internal principles and rules by Member States is not enough<sup>38</sup>.

That is why one of the conditions of granting aid as part of the ESM should be the prior consent and involvement of the IMF in the financing. The IMF's involvement at the early stage allows to create objective framework for the evaluation of the situation and increase in a sense of responsibility for the budgetary policy<sup>39</sup> in potential aid beneficiaries.

Additionally, the present structure of the aid programme does not guarantee effectiveness of the mechanism as regards overcoming present and future crises. What arises the most doubts, though, is the size of the fund and the cost of its functioning (within the meaning of the potential to obtain the financing on the market). The IMF's involvement offers an opportunity for the recapitalisation of the aid mechanism.

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<sup>38</sup> The violation of the provisions of the SGP or Article 125 of the TFEU shows how easy it is not to comply with one's own rules.

<sup>39</sup> In the long run no aid package may replace necessary structural reforms supporting the economic growth. Briefly speaking, the activities of particular countries should focus on the restoration and maintenance of the fiscal policy, strengthening of the financial supervision, increasing competitiveness, increasing flexibility of the labour market and reducing costs of the work force.

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## THE ESM – WHAT IS BEHIND THE PROPOSITIONS?

### Summary

The debt crisis revealed serious gaps in the hitherto economic management system of the European Union. First of all, the principles of the Stability and Growth Pact (SGP) turned out to be completely ineffective, since they did not prevent the European Union from getting into trouble as a result of irresponsible fiscal policy. Secondly, it became clear that the euro area had no instruments for management in a critical situation, which made it impossible to undertake relevant actions. In May 2010, the EU started to look for an answer to the question how to overcome the crisis. Special rescue funds were established to prevent the crisis from spreading all over Europe. In the article, the author analyses the quality of the EU decision (at the moment the decision was taken) and the potential effectiveness of the proposed aid system architecture.

## ESM – CO SIĘ KRYJE ZA JEGO PROPOZYCJAMI?

### Streszczenie

Kryzys zadłużenia ujawnił poważne luki w systemie zarządzania gospodarczego Unii Europejskiej. Po pierwsze, zasady Paktu Stabilności i Wzrostu (SGP) okazały się całkowicie nieskuteczne, ponieważ nie uchroniły Unii Europejskiej przed konsekwencjami nieodpowiedzialnej polityki fiskalnej. Po drugie, okazało się, że strefa euro nie miała instrumentów zarządzania w sytuacji kryzysowej, co uniemożliwiło podjęcie stosownych działań. W maju 2010 roku UE rozpoczęła szukanie odpowiedzi, jak wyjść z kryzysu. Powołano specjalne fundusze ratunkowe, aby zapobiec rozprzestrzenianiu się kryzysu w całej Europie. W artykule autor analizuje jakość podejmowanych wówczas decyzji oraz skuteczność tworzonego mechanizmu pomocy.

## ЕВРОПЕЙСКИЙ МЕХАНИЗМ СТАБИЛЬНОСТИ – ЧТО СТОИТ ЗА ЭТИМ ПРЕДЛОЖЕНИЕМ?

### Резюме

Кризис задолженности выявил серьёзные пробелы в структуре экономического управления Европейского союза. Во-первых, принципы Пакта Стабильности и Роста (SGP) оказались совершенно неэффективными, поскольку не защитили Европейский союз от последствий безответственной налогово-бюджетной политики. Во-вторых, как оказалось, еврозона не обладала инструментами управления в кризисной ситуации, что привело к невозможности принятия соответствующих мер. В мае 2010 года Евросоюз приступил к поиску ответа на вопрос о том, как выйти из кризиса. Задействованы специальные спасательные средства, чтобы предотвратить распространение кризиса по всей Европе. Автор статьи анализирует качественный уровень принимаемых в связи с этим решений, а также эффективность применяемого механизма помощи.