DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

ECONOMIC AND MONETARY AFFAIRS

The EFSM and the EFSF: Now and what follows

NOTE

Abstract

In this paper, I consider the consequences of the decision to establish the European Financial Stabilisation Mechanism and the European Financial Stability Facility. These facilities are temporary in nature and I also consider alternative ways to support the financial stability of the euro area.

IP/A/ECON/FWC/2009_040/C7 **8 Sep 2010**

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

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LINGUISTIC VERSIONS

Original: [EN]

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Manuscript completed in September 2010.
Brussels, © European Parliament, 2010.

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Executive Summary

- In early May 2010 fears that the Greek sovereign debt crisis might prove costly and contagious led to the establishment of new lending facilities. The facilities are an attempt to allow financially troubled euro area member states to borrow at attractive rates.

- The new facilities have some problems. First, the legal foundation for their existence is shaky. Second, the EFSF may have difficulty attaining and maintaining a AAA credit rating.

- The rescue plan created over the weekend of 8 – 9 May included both the EFSM and EFSF and the ECB's securities market program. It was followed by an immediate drop in sovereign interest rate differentials but these differentials have been drifting up since then.

- The history of the Greek debt crisis and the experience with the Stability and Growth Pact suggest that fiscal criteria are unenforceable, and hence, of little use in ensuring financial stability.

- The interest rate differential between Greek and German government bonds was still surprisingly low at the end of 2009. Insufficient surveillance and the seeming complacency of EU and other policy makers may have played a role.

- Independent councils of auditors and fiscal experts might improve the ability of markets (and voters) to discipline errant fiscal policy makers.

- The permanent existence of facilities such as the EFSM and the EFSF creates a serious moral hazard problem by lowering the risk to a sovereign of following a fiscal policy that might prove to be unsustainable.

- Better supervision and regulation would have made the possibility of a Greek sovereign default less costly and could also be expected to lower the costs of other sovereign defaults.

In this report, I consider the consequences of the establishing the European Financial Stabilisation Mechanism and the European Financial Stabilisation Facility. As these these institutions are temporary in nature, I consider permanent solutions to support the financial stability of the euro area.

1. The Consequence of the EFSM and the EFSF

In early May 2010 fears that the Greek sovereign debt crisis might prove costly and contagious led European Union policy makers to approve three new lending facilities for euro area member states in serious financial distress. In this section I describe how the facilities work and how effective the the EFSM and EFSF have been.

1.1 The New Lending Facilities

The first facility is a 110 billion euro support package for Greece, approved on 3 May and provided jointly with the IMF, comprising an 80 billion euro facility from euro area countries and a 30 billion euro Stand-By Arrangement with the Fund. The second facility is the European Financial Stabilisation Mechanism (EFSM) with a volume 60 billion euros. It is administered by the European Commission and is similar to the facility that had previously been set to help the non-euro area countries Latvia, Hungary and Romania. The third facility is the European Financial Stability Facility (EFSF): a special purpose vehicle set up to make loans to euro area countries, other than Greece, up to an amount of 440 billion euros, supplemented with a 250 billion euro IMF commitment. Both the EFSM and the EFSF were agreed by ECOFIN the weekend of 8 – 9 May. Clearly the EFSF is potentially the most important of these three facilities. Set up as a limited liability company owned by euro area member states and located in Luxembourg, it became fully operational on 4 Aug 2010. Loans made by both the EFSM and the EFSF have terms and conditions similar to those made by the IMF and both of these facilities are temporary: they will make no new loans after three years.

1.2 The Rationale for and Problems with the EFSM and EFSF

The rationale for the three new facilities is as follows. Euro area countries have followed unsustainable fiscal policies. Greece is facing a sovereign debt crisis and Portugal, Ireland, Italy and Spain may be in danger, as well. As a result, borrowing costs for many euro area countries are extremely high, tending to make their fiscal situation even worse. The new facilities were created by European Union policy makers to lower the borrowing costs of financially troubled countries. The idea is that if the euro area borrows as a whole, it can get better rates than a troubled country can and it can pass on these rates to this country.
Unfortunately, the lower borrowing costs come with a political problem. If some euro area countries must make good on the euro area's guarantee as a whole in the case of one or more other euro area countries defaulting, then this is a transfer of wealth from these countries to one or more others. It may be seen as a violation of the so-called "no bailout clause", Article 125.1 of the Treaty (consolidated version) which says:

> *The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.*

In the case of the Greek rescue package, it is likely that expediency overcame the aversion that more fiscally prudent countries had toward bailing out more profligate countries. German and French banks were highly exposed to Greek debt and these countries feared their banking systems would be destabilised by a Greek sovereign default. Other troubled euro area countries probably envisioned themselves as possible beneficiaries of similar packages sometime in near future.

The EFSM's debt is backed by the EU budget; hence, its securities are viewed as good quality. However, given article 125.1, this joint and several guarantee raises troubling questions about its legality. Its legal justification is supposedly derived from Article 122.2 of the Treaty (consolidated version) which states that "[w]here a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned." However, in the case of the European sovereign debt crisis it is difficult to argue that the severe difficulties faced by some member states where akin to being hit by hurricanes or earthquakes, rather than being mostly of their own making. Presumably, little issue was made of the question of legality because of the small size of this facility.
The EFSF is an attempt to provide a much larger facility, made more politically palatable by changing the nature of its guarantee. It is to work by issuing bonds and using the proceeds to make loans. The bonds are guaranteed on a pro rata basis by participating member states in a coordinated fashion. That is, instead of a joint and several guarantee, there are individual guarantees; as with the the EFSM, there is no collateral. Each country's share of the total guaranteed amount is equal to its share of the ECB's capital. The total amount of the guarantees will cover 120 percent of the debt issued and there is to be an additional cash reserve accumulated by fees paid by member states that access the facility. European Union politicians hope that it will be given an AAA rating, allowing troubled euro area member states to borrow at highly favourable rates.

Unfortunately, even with the 20 percent extra guarantee, there are obstacles to attaining and maintaining the hoped-for AAA rating. First, as shown in Table 1 below, only six of the individual member states providing the guarantees have (Fitch) AAA ratings themselves and many have dismal credit ratings. Second, the fortunes of the highly indebted Euro area countries are correlated. Thus, the quality of the collateral is correlated with the fortunes of a potential borrower. Third, debt is issued by the ESFS only after a loan is requested; in this scenario the credit worthiness of Euro area countries would likely be even lower than it is currently.

Table 1. Euro area credit ratings[*]

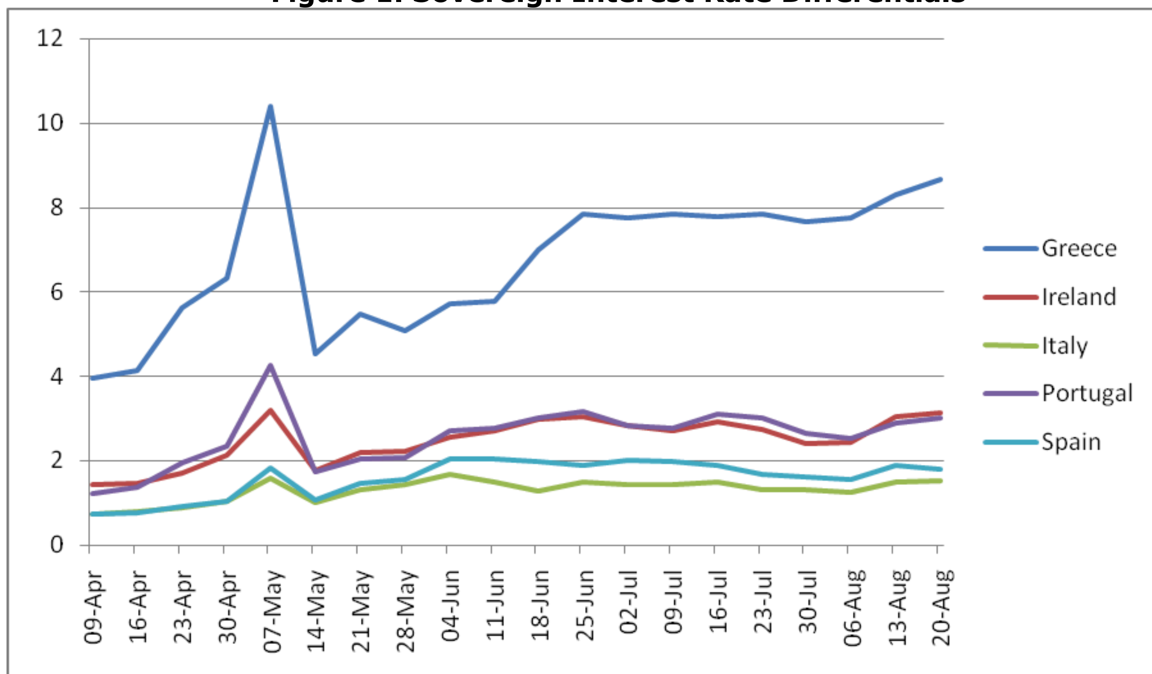
Country	Rating	Country	Rating
Austria	AAA	Italy	AA-
Belgium	AA+	Luxembourg	AAA
Cyprus	AA-	Malta	A+
Finland	AAA	Netherlands	AAA
France	AAA	Portugal	AA-
Germany	AAA	Slovakia	A+
Greece	BBB-	Slovenia	AA
Ireland	AA-	Spain	AA+

[*]Fitch, long-term foreign and local currency Issuer Default Rating

1.3 How well have the New Lending Facilities Worked?

The new lending facilities, even in combination with dramatic action by the ECB, have failed to be the needed panacea to Europe's fiscal crisis. A measure of the markets' faith in the efficacy of the euro area policy response is provided by the differential between the troubled euro area countries' 10-year government bond interest rates and those of Germany, shown in Figure 1, below. As is seen, interest rate differentials spiked in early May. Over the weekend of 8 – 9 May European Union policy makers created a rescue plan that included the EFSM, the EFSF and the ECB's "securities market program": a plan to intervene in dysfunctional public and private debt markets. In the face of a crisis, immediate but imperfect government action may have a better short-term effect than delay in search of a more perfect solution and interest rate differentials fell sharply: the immediate threat of sovereign default was averted. Unfortunately, the effect was short lived: interest rate differentials have been steadily drifting up since then.

Figure 1. Sovereign Interest Rate Differentials*



*10-year government bond spreads vs. Germany, source: *Financial Times*

2. What should euro area policy makers do next?

In this section I address the issue of longer run reforms. But, before thinking about what institutions Europe needs to ensure the stability of the euro and the financial stability of the euro area, it is interesting to ask how the Greek debt crisis came to happen and why the existing arrangements did not stop it.

2.1 A Brief History of the Greek Debt Crisis

According to the 2000 IMF Article IV staff report, Greek government budget deficits had fallen from 10.2 percent of GDP in 1995 to an estimated 1.8 percent of GDP in 1999, while Greek government debt had fallen from an estimated 108.7 percent to 104.6 over the same period. While apparently satisfying the Maastricht criterion that the budget deficit must be less than three percent of GDP, Greece was clearly in violation of the criterion that debt must be less than 60 percent of GDP. Nevertheless, it was welcomed into the euro area under the allowed pretext that the ratio was "sufficiently diminishing and approaching the reference value at a satisfactory pace".

In 2004 it was revealed that, as seen in Table 2 below, Greece had, through some combination of ineptness and underhandedness, misrepresented its data. Greek government budget deficits had *never* fallen below the three percent target in the years 1997 – 2003 and government debt was expected by the IMF to be 112 percent of GDP in 2004; it had fallen little over the previous few years. Not only had Greece failed to satisfy the Maastricht criteria but it was in flagrant violation of the Growth and Stability Pact.

Table 2. Greek Data in 2004, before and after revision*

	1997	1998	1999	2000	2001	2002	2003
	Government budget deficits (as a percentage of GDP)						
Unrevised	4.0	2.5	1.8	2.0	1.4	1.4	1.7
Revised	6.6	4.3	3.4	4.1	3.7	3.7	4.6
	Government debt (as a percentage of GDP)						
Unrevised	108	106	105	106	106	105	103
Revised	114	112	112	114	115	113	110

**Revised data is from Feb 2004, Source: IMF, Greece: 2004 Article IV Consultation: Staff Report.*

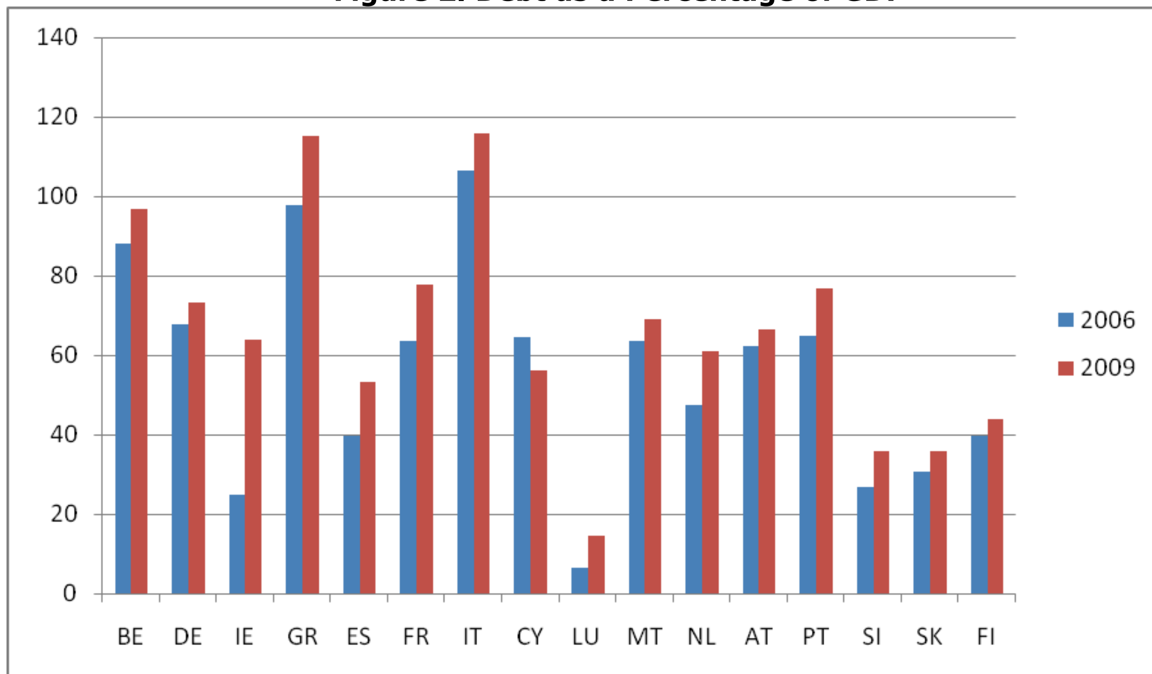
At the end of September 2006, under pressure to improve its fiscal performance, Greece announced that after including its informal economy, its GDP was actually about 25 percent higher than previously thought. Thus, its debt was really only 85.3 percent of GDP. Despite the new numbers, in 2008 Greece announced a preliminary government budget deficit of 5.0 percent of GDP and debt that had grown to 98 percent of GDP: a continued violation of the Pact. Even this was untrue: in November of that year, the government admitted that the budget deficit was actually 7.7 percent of GDP and that it would be 12.5 percent in 2009, rather than the previously reported 3.7 percent. Eurostat later revised the 2009 figure to 13.6 percent. Government debt in 2009 was reported to be 115.2 percent of GDP.

2.2 The Greek Debt Crisis and the History of the Euro Area suggest that Fiscal Targets are not a Solution

Throughout the current crisis, policy makers have discussed improving the functioning of the Stability and Growth Pact as a way of ensure financial stability in the euro area.[1] However, an important lesson from the Greek crisis is that policy makers lack the political will to enforce fiscal targets, at least for west European countries. Despite their remarkable squeamishness in refusing Lithuania entry to the euro area when it violated the inflation criterion by a hair's breadth, they were unable to deny Greece entry when it was in obvious violation of the fiscal criteria.

This lesson is reinforced by the histories of most of the other members of the euro area. Prior to the liquidity and credit crisis (in 2006), Greece, Italy and Portugal were running government budget deficits equal to 3.6, 3.3 and 3.9 percent of GDP, respectively. Even Germany has regularly breached this target. More importantly, as seen in Figure 2, below, nine out the 16 current Euro area member states had debt that was over 60 percent of GDP in 2006; ten were in violation in 2009.

Figure 2. Debt as a Percentage of GDP*



*Source: ECB

Fiscal criteria are never going to function as intended unless violators are punished. As the experience of Greece and the history of administering the Pact has shown, this is not currently politically feasible.

[1] See, for example, Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the Economic and Social Committee and the Committee of the Region, *Reinforcing Economic Policy Coordination*, Brussels, 12 May 2010.

2.3 What does the Greek Debt Crisis say about Markets' Ability to Police Sovereigns?

It is interesting to ask why the markets allowed the Greek debt crisis to happen. It seems remarkable in hindsight that interest rates on Greek sovereign debt did not rise sharply long before they did. If the markets had forced Greece to pre-emptively restructure its debt in, say, 2004, the impact on Europe would have likely been much smaller than it would be in the aftermath of the financial crisis. Greece would have been forced to curtail its borrowing and those who invested in Greek debt would have paid for not being more vigilant. Perhaps other fiscal policy makers and investors would have become more cautious. Markets, however, remained stunningly serene: the interest rate differential between 10-year Greek and German government bonds hovered at around half a percent through 2007. By the end of 2008 it had reached 2.25 and was only 2.41 at the end of 2009. Greek sovereign 9-year CDS rates did not rise above 100 basis points until late 2008.

The interest rate response suggests that a lesson from the Greek debt crisis is that markets cannot be expected to discipline errant policy makers. This may not be true, however. A lack of good policy making and may have hindered the market's ability to function effectively. I provide two examples of how this might have occurred and explain what can be done to improve matters. It should also be noted that this same lack of good policy and intervention may also have rendered Greek voters complacent.

2.4 Better Surveillance is needed

First, markets lacked the data to make informed judgements. Greece has consistently been responsible for wildly inaccurate fiscal data: the market may have thought that the situation was less dire than it actually was. One way to remedy might be to appoint an independent committee of experts that would audit the fiscal accounts and plans of each member state.[2]

Second, the complacency of policy makers, who may have been perceived as being better informed, may have led markets to think that things were less serious than they were. Euro area policy makers, however, were apparently unwilling or afraid to speak out. The ECB blithely continued to accept Greek sovereign debt on the same terms it accepted German sovereign debt: there was no additional haircut for liquidity risk. Outside of the euro area, it must have been obvious to the IMF as far back as 2004 that Greece was likely headed toward disaster, but the Article IV reports are restrained. One solution to this problem would be the creation of an independent fiscal council that would allow a non-political expert evaluation of national budgetary plans.[3] Perhaps Article IV reports should not have to be approved by the IMF Board. Academic economists – who rarely feel constrained in saying what they think – might be rewarded less for doing blue sky research and more for doing policy analysis.

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[2] See Burda, Michael and Stefan Gerlach (2010), "A Credible Stability and Growth Pact: Raising the bar for budgetary transparency," in Baldwin Richard, Daniel Gros and Luc Laeven, eds., *Completing the Eurozone rescue: What more needs to be done*?, VoxEU.org.

[3] See Fatás, Antonio, Jurgen von Hagen, Andrew Hughes Hallett, Anne Sibert and Rolf R Strauch (2003), *Stability and Growth in Europe: Towards a Better Pact*, CEPR.

2.5 It should be more Costly for Governments to Follow Bad Fiscal Policies

If euro area policy makers cannot be *forced* to follow a fiscal policy that is likely to be sustainable, then it should be made in their best interests to do so. As previously noted, the EFSM and EFSF will make no new loans after three years. This is probably a good thing. The problem in the Euro area is that too many countries have borrowed too much. Facilities that allow them to borrow more at attractive rates are not the long-run solution to the problem. Indeed, the permanent existence of such facilities creates a serious moral hazard problem by lowering the risk to a sovereign of following a fiscal policy that might prove to be unsustainable.

A usual counterargument is that such facilities protect countries that would be solvent if it were not for contagion. In the current crisis there exists a possibility that a Greek default might make runs on countries that have similar features to Greece – Ireland, Italy, Portugal and Spain – focal. The existence of lending facilities lowers the cost of looking like Greece. However, their absence would lower the likelihood of a country following a rash fiscal policy: the possibility of runs on the debt of countries that look like Greece may be a valuable commitment device for countries that choose not to look like Greece.
In addition to expected bailouts increasing the likelihood of default, they may be another reason that markets did not react to the ballooning Greek debt. Many traders must have possessed a (not entirely irrational) belief that Greece would be rescued.

2.6 Make Sovereign Defaults less Costly

Sovereign defaults are possible, even when policies are sound. Thus, euro area policy makers should take steps to ensure that the euro area financial system is less vulnerable to sovereign defaults. The likely reason that a Greek default is seen as so costly is the heavy exposure of some euro area countries' banking systems to Greek debt. The Greek debt crisis may be – to a great extent – a German and French banking crisis in disguise. The solution to this is better supervision and regulation of national banking systems.