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On the Tasks of the European Stability Mechanism

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1. Introduction

In recent weeks pressures on the euro and eurozone sovereign debtors have subsided. Buoyant growth in the global economy, increasingly benefiting also the European economy, has of course played an important role in calming financial markets. But even more important has been the perception that France and Germany are again working constructively for a strong economic Europe. More broadly, the acute turbulence in financial markets since the spring of 2010 may have finally convinced our political leaders, notably including the German political establishment, that the benefits of a stable currency far outweigh the costs that may have to be borne to make it work properly. The euro will only be trusted if the member states effectively coordinate their economic policies not only to ensure fiscal stability, but also to eliminate persistent divergences in productivity leading to unsustainable imbalances between national savings and investment (Schäuble, 2011).

At its forthcoming spring meeting, on March 24th-25th, the European Council will consider a comprehensive package of measures that can open a new age of European economic governance: truly collective, rather than intergovernmental, and rule-based; capable of enforcing economic policy coordination and preventing the build-up of unsustainable imbalances in government as well as private balance sheets; and backed up by credible, quasi-automatic sanctions for any member state posing a threat to collective stability.

While the broad set of measures required to bring about coherent and sustainable macro-financial polices has been identified, much confusion remains as to what exactly common policies can and should do to tackle the sovereign debt crisis of ‘peripheral’ eurozone countries. As a result, the discussion on the new European Stability Mechanism (ESM) has been plagued by misunderstandings and confusion, often amplified by politicians pandering to domestic public concerns.

This Policy Brief aims to contribute to Council deliberations first by clarifying the proper role of Union financial assistance to member states confronted with sovereign debt crises, which should in no case cross the line of providing fiscal transfers; and, second, by outlining the tasks that the new ESM should be able to perform if we really want an effective and credible crisis management system for both the eurozone and the European Union. Proper design of the ESM should also allow the debate about euro or, rather, Union-bonds to be brought to a fruitful conclusion.

This Brief is organized as follows. Section 2 briefly reviews the key elements under discussion in the new EU economic governance. Legal limits of financial assistance to member states under the TFEU are discussed in section 3, and sovereign debt restructuring arrangements in section 4. The

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ingredients of a credible system for bank crisis resolution are described in section 5 and section 6 then discusses the possible role of Union–bonds in facilitating debt restructuring and bank resolution, consistent with the no-fiscal-transfer Treaty constraint. Finally, section 7 brings the pieces together to describe the desirable tasks of the ESM.

2. EU economic governance: The broad picture

An effective crisis management framework must rest on the three pillars of crisis prevention, crisis mitigation and crisis resolution (Kapoor, 2010).

Crisis prevention comprises the new rules on policy coordination, including the European semester, the revised stability and growth pact and the excessive imbalances procedure – which can find proper content in stronger economic governance effectively concentrating on pro-competitive market opening structural reforms. The critical aspect for success will be procedures ensuring that budgetary discipline and other policy rules equally apply to all member states. To this end, the best guarantee would be semi-automatic rules under strong surveillance and enforcement powers by the European Commission, assisted by reverse majority voting in the Council on all Commission recommendations. Experience has shown over and over again that intergovernmental decision-making and peer pressure will not suffice, as once again Verhofstadt, Delors and Prodi (2011) forcefully reminded us in their recent editorial in the Financial Times. Moreover, as has been argued by Amato et al. (2010), the common economic policies must rest on the twin legs of financial stability and a strategy capable of durably raising the growth of output and productivity throughout the eurozone. Without the growth leg, the stability leg is also bound to falter.

A central role in preventing a repetition of financial excesses of the past decade will be played by financial regulation (Visco, 2011). Stronger rules on capital and liquidity standards for banks, risk-based deposit insurance, central clearing for derivatives and new governance rules for financial institutions (e.g. on remuneration and risk control) are all in the pipeline and should deliver a structurally stronger financial system.

It is also critically important to contain pro-cyclicality of the financial system, basically by empowering national central banks, under a common ECB procedure, to vary capital and reserve requirements for anti-cyclical purposes (De Grauwe, 2010). This is not only an issue internal to the financial system, as such already under intense examination in the Basel III framework, but a broader issue of macroeconomic stability: in an economic area where financial integration is more advanced than labour and services market integration, the single monetary policy may result in divergent real interest rates, leading locally to unwanted credit expansions or contractions – as was notably the case in Ireland and Spain in the past decade. This problem may soon become a hot issue, if the ECB decides to raise interest rates in response to strong demand and accelerating wages in Germany while the periphery still is in the doldrums.

On crisis mitigation, the panoply of instruments deployed by the EU has on the whole succeeded – albeit at larger costs than necessary due to publicly voiced disagreements between key member states on the nature and scope of assistance to distressed sovereign debtors (Micossi, 2010). The European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM), along with decisive action by the ECB, have finally convinced financial markets that a disorderly default of a eurozone member state is not in the cards. The key question now is how to manage the transition from temporary liquidity assistance to medium-term support for the time needed by distressed sovereign debtors to regain access to private financing.

A stable financial system requires strong rules to ensure that all debtors must pay back their debts or confront bankruptcy. This is the issue of crisis resolution: a key component of financial regulation whose design in the Union is not yet in sight – despite the loud calls for 'haircuts' on private creditors by virtuous eurozone members. However, sovereign debt restructuring can only happen if there is a credible system for bank crisis resolution. Indeed, it was reckless lending by core-country eurozone banks that made it

possible for the periphery to accumulate unsustainable debts – both by the public and the private sector (see also Bruton, 2011). The discussion about making the private sector share in the costs of reckless borrowing by sovereign debtors inevitably is at the same time a discussion about making banks write off the losses on their bloated sovereign portfolios – with all the consequences this would entail for bank capital.

The main source of moral hazard in the financial system of the eurozone has been the implicit promise that banks would be bailed out by governments: a promise made good once again by the Greek and Irish rescue packages, which have exempted banks from all losses and have placed their losses squarely on taxpayers' shoulders. In the absence of arrangements making it possible for large cross-border banks within the eurozone to take large losses and even fail without destroying the entire financial system, bankers may soon revert to excessive risk-taking in the well-founded belief that taxpayers will pay for their mistakes. And, as a result, market discipline will remain weak also on sovereign debtors.

3. Financial assistance without fiscal transfers

Before venturing into the discussion of debt restructuring and resolution procedures, it is wise to recall briefly the legal limits posited by the Treaty on financial support granted by a Union institution or the member states, individually and collectively, to a member state experiencing serious difficulties in its balance of payments or that has lost access to private credit markets.

Article 125 TFEU contains the so-called 'no-bail-out' provision, whereby neither the Union nor a member state "shall be liable for or assume the commitments of" any public body or entity of any member state, "without prejudice to mutual financial guarantees for the joint execution of a specific project". This certainly excludes any possibility of direct fiscal transfers from one member state to another, in order to help the latter meet its debt obligations, as well as the assumption of guarantees for those liabilities.

It does allow, however, for the possibility of separate and joint guarantees for a joint project, an expression that may well include financial assistance to a member state, provided two conditions are met:

i. financial assistance provided to a member state must respond to the purpose of preserving financial stability, that is to avoid unwanted systemic fallout from a local crisis and,

ii. financial assistance to a member state, or any other operation undertaken in that connection, does not result in a fiscal transfer to the member state concerned or a guarantee for its liabilities.

The possibility of granting financial assistance to a member state is already recognized explicitly in the TFEU:

i. for a non-eurozone country, when the member state is experiencing balance-of-payments difficulties of a magnitude that may jeopardize the functioning of the internal market or the implementation of the common commercial policy (Article 143); and

ii. for a eurozone country, resort can be made to Article 122.2, providing that the member state "is in difficulties or seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control." This article indeed provided the legal basis for granting financial assistance to Greece and for establishing the eurozone emergency package in May 2010.

Thus, as noted by Pisani-Ferry (2010), there was never a 'no-assistance principle' in the Treaty. What may be questioned, and has been questioned, is whether Greece and Ireland, and possibly others, are falling 'in difficulties' as a result of events beyond their control or rather their own policy mistakes. On one hand, the financial crisis was a global phenomenon originating beyond their borders; on the other hand, its consequences were exacerbated by domestic policies and, in the case of Greece, overt violation of the stability and growth pact (aggravated by false reporting). This question may at all events be beside the point, to the extent that one country's policy mistakes may destabilize the entire eurozone financial system regardless of its causes.

Precisely to overcome any ambiguity on the legality of financial assistance, at its last meeting, on 16-17 December 2010, the European Council

decided to modify Article 136 of the TFEU by adding a paragraph that will establish a permanent stability mechanism able to provide financial assistance to a eurozone member state when this is "indispensable to safeguard the stability of the euro area as a whole". Financial assistance will be provided "upon request and under strict conditionality" (cf. European Council Conclusions, Annex I). Resort for this Treaty amendment to the accelerated procedure of Article 48.6 of the TEU reflects agreement in the Council that no change is involved in Union competencies but it is rather a matter of clarifying what was already legal. On financial assistance to the member states, it is worth quoting again Wolfgang Schäuble's speech at Humboldt University last January, where he clearly stated that the assistance measures to Greece and Ireland "are compatible with our constitutional and European law … The loans are not transfers. And they are not gifts. ... And the conditionality is such that the country is compelled to enforce measures that would have been unthinkable before the event."

Financial assistance may well take different forms, provided it helps alleviate the member state's difficulties: extending a loan to rollover sovereign debt, but also intervening in distressed markets to restore normal conditions, or exchanging Union bonds for sovereign debt held by the private sector, provided it is undertaken at market prices, would all qualify as permissible acts of financial assistance.

In sum, under the Treaty the ESM may be entrusted to provide financial assistance to a eurozone member state, and raise the necessary means by issuing Union bonds, but would not be allowed to use this money to transfer permanently resources to the member state concerned, or provide guarantees on its sovereign debt, since this would violate the no-bail-out clause of Article 125. As long as these conditions are respected, a decision by the member states to guarantee ESM obligations jointly, rather than separately and pro-quota as under the present EFSF arrangements, would seem fully compliant with the Treaty.

4. Debt restructuring

The financial assistance programmes for Greece and Ireland have provided bridging finance for a limited period – until 2013 – but have not restored debt sustainability, among other things because the cost of financing is well above nominal growth and private creditors have not been asked to share losses, placing an unbearable burden on taxpayers, which is undermining the economic as well as political sustainability of corrective measures (Buiter and Rahbari, 2010; and Eichengreen, 2010). Table 1, based on recent estimates by The Economist, summarizes debt sustainability indicators for the two countries that already receive financial assistance, as well as Portugal and Spain.

Table 1. Sovereign debt sustainability in eurozone periphery (% of GDP, unless stated)

	Gross government debt		Primary budget adjustment, 2010-15 f'cast	Net international investment position, 2009	Gov't bonds held abroad[1] (%)	10-yr gov't bond yield[2] (%)
	2010 estimate	2015 f'cast				
Greece	140.2	165	10	-89.1	58	11.3
Ireland	97.4	125	13	-102.5	54.2	8.3
Portugal	82.8	100	8	-113.2	66	6.8
Spain	64.4	85	10	-95.7	38.7	5.5

[1] Q3 2010.

[2] 12 January 2011.

Source: *The Economist*, 15 January 2011.

As may be seen, even after fairly dramatic adjustments in the primary balance, neither Greece nor Ireland can stop, let alone reverse, the increase in debt-to-GDP ratios, which in 2015 are forecast to top respectively 165% and 125%. The effective cost of Union/IMF financial assistance, in both instances at close to 6%, is in part responsible for this adverse debt dynamics, since it largely exceeds the nominal growth rate of GDP (with an estimated average in 2011-15 of around 2% for Greece and 3.5% for Ireland, with a slower profile in the early programme years).[1] And market interest rates on their sovereign bonds are higher still, precluding any return to private markets any time soon.

Portugal's public finances are in less dire conditions, but the country suffers from a large exposure to foreign markets, which makes its financial position vulnerable to sudden changes in market confidence. While the desire to avoid asking for financial assistance is understandable, an early decision to seek such assistance may calm markets and reduce the required adjustment effort – provided of course the assistance does not come yet again at a punitive cost. As for Spain, the probability that it may need financial assistance seems slim, especially after the measures taken recently to strengthen the savings banks (Cajas de Ahorros). Despite its high debt-to-GDP ratio, Italy has managed to keep off the radar screen of short-sellers by its prudent fiscal policies.

All in all, barring new unforeseen shocks to the world economy, it seems unlikely that the total bill of financial assistance to the eurozone periphery will exceed the maximum total available under last May's Council package, i.e. €750 billion (including €250 billion committed by the IMF) – keeping in mind that, in order to make the promise effective, the guarantees offered by the core eurozone members for utilization of the eurozone facility will have to be raised.

On the other hand, liquidity support cannot resolve a solvency problem. Failure to address the issue of solvency with proper instruments will only exacerbate adjustment costs and raise the spectre of disorderly default, with high risks of financial fallouts on the entire eurozone. Clearly, financial assistance to Greece and Ireland will need to be provided well beyond the current three years period, and adjustment programmes will need to be revised to lengthen debt repayment and make private creditors take their fair share of losses. Therefore, there is little doubt that the Union urgently needs effective arrangements for debt restructuring – even if this might entail the need for creditor banks to recapitalize (Kapoor, 2010; Gros and Mayer, 2011).

Traditionally, two main approaches have been proposed to debt restructuring: a centralized statutory approach and decentralized resolution entrusted to agreements between private parties, in both cases assisted by appropriate legal provisions.

The statutory approach, as prominently advocated by the IMF in the early 2000s (Krueger, 2002), and more recently by Lamandini (2010), requires a transnational unified legal bankruptcy framework and an international court to manage the procedure and adjudicate controversies in individual cases. In rejecting the proposal as overly centralized, the US Treasury advocated a market-based contractual mechanism with 'carrots and sticks' incentives. According to this approach, creditors and debtors would be encouraged to write in their contracts provisions relating to debt restructuring – prominent among them collective action clauses that would allow a qualified majority of the holders of a bond issue (typically 75%) to take decisions on a change of the terms of the debt which is also binding for the minority, thus overcoming creditor free-riding problems. In both cases the legal framework must include provisions for stay of execution, following the model of Chapter 11 and Chapter 9 of the US Bankruptcy Code.[2]

The voluntary decentralized approach seems better fitting for the EU – also in view of the

[1] Cf. for Greece, IMF (2010), "Greece: Second Review under the Stand-By Arrangement-Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Greece", December. For Ireland, cf. IMF (2010), "Ireland: Request for an Extended Arrangement—Staff Report; Staff Supplement; Staff Statement; and Press Release on the Executive Board Discussion", December.

[2] The latter imposes an automatic stay on creditor claims against a municipal or county government, so as to give the sovereign debtor sufficient time to formulate a restructuring plan and obtain creditor approval.

hurdles involved in creating a single bankruptcy framework for its diverse membership. Under this approach, an EU directive or, better, a regulation could establish broad principles and guidelines to be followed in all sovereign debt contracts that would facilitate restructuring negotiations – and nothing more, so as to avoid formidable legal obstacles (Alexander, 2010).[3] In December 2010 the European Council has already agreed that all sovereign bond issues by eurozone countries should carry collective action clauses starting in June 2013.

The main benefit of market-based solutions is that they minimize financial disruptions since they are already discounted by financial markets; it is debatable whether the cost of sovereign debt will increase or decrease. A key issue is under what circumstances creditors and debtors may find it preferable to agree out of court on changing outstanding contracts rather than respectively claiming full payment in court or stopping payments. As a general principle, a creditor will agree on 'haircuts' if a reduction in nominal claims increases his total expected payment flow (Krugman, 1988). His incentive to come forward and negotiate in good faith may be strengthened in certain cases – e.g. impaired credits in banks balance sheets – by strict prudential rules on write-offs. As for insolvent debtors, early recognition of the problem may be encouraged by the existence of a credible framework for debt restructuring, while moral hazard may be tackled by tough conditionality.[4]

In the wake of this debate, the paramount example of (quasi-) voluntary restructuring was the Brady Plan launched in 1989 by the US administration to resolve the Mexican sovereign debt crisis. Banks holding Mexican sovereigns accepted to exchange them at an agreed discount with new Mexican government securities backed by US Treasuries as collateral for the principal, while the Mexican government set up an escrow account for securing interest payments. The IMF and the World Bank lent Mexico the money required to purchase the Treasuries to be set aside as collateral for the new debt (Buchheit, 2010). The scheme was later used to restructure the sovereign debt of other emerging countries. This solution was attractive to banks because it averted an outright default, and to the Mexican government because it allowed a negotiated reduction in the debt burden down to manageable proportions. And yet, perhaps an agreement wouldn't have been forthcoming without strong pressure from the US government, pointing to the useful catalyzing role of public authorities in cajoling the parties to make serious concessions.

A market-based solution to debt restructuring that shares some features of the Brady Plan has been proposed by Gros and Mayer (2011). In their approach, the ESM would issue Union bonds to buy sovereign distressed debt at market price, and then turn it back to the issuer with conditions set under the financial assistance programme. The key issue once again is to convince creditors to swap their sovereign bond holdings at market price, thus immediately taking the full loss on their distressed sovereigns: as already mentioned, tougher prudential rules on loss recognition by banks may play a central role in this connection. Further credit enhancement as under the Brady Plan may also be advisable. We will come back to this scheme in section 7. We must now turn our attention to bank crisis resolution, the other main element required – together with sovereign debt restructuring rules – in order to combat moral hazard in the financial system and restore market discipline.

5. Bank crisis resolution

As has been argued, unsustainable sovereign debt accumulation by certain eurozone governments is closely intertwined with reckless lending by core eurozone banks, directly to the government in the Greek case and in the Irish case to the private sector which later fell back onto the government. Restoring debt sustainability will not be feasible unless the banks take their share of losses on bad loans. Strong crisis management and resolution procedures for the banks are required both to let losses fully emerge and to make sure that banks will not repeat the same mistakes in the future.

[3] Alexander also advocates the creation of an EU sovereign debt agency, which we do not regard as necessary.

[4] In any event, the notion that sovereign debtors will only base their decision to default on their debt strictly on economic optimization, as e.g. in Buiter and Rahbari (2010), is not convincing, since it underplays the domestic political and social costs of such a decision (for more on this, see Bini Smaghi, 2010).

What follows summarizes the recommendations of a CEPS Task Force on bank crisis resolution (Carmassi et al., 2010).

A coherent and comprehensive approach to bank crisis resolution should be based as much as possible on existing powers and institutional arrangements; given the challenges posed by the heterogeneity across national rules on crisis management and resolution, legal changes should be sought only as strictly required. Full harmonization of bankruptcy laws is in general not necessary, as long as all the member states adhere to a number of key principles for bank crisis management and resolution.

First, all the member states should have similar administrative powers for early corrective action and resolution of a bank crisis, as recommended by the Basel Supervisors (BCBS, 2009): they would include the power to order recapitalization, change management, dispose of assets and create a bridge bank that would take over the good assets of an entity heading for liquidation.

Second, crisis prevention, resolution and liquidation would all be part of a unified crisis management and resolution procedure managed for each bank or banking group on a consolidated basis by the supervisory authority of the parent company, assisted by a College of supervisors comprising representatives from all the countries where the banking group has branches or subsidiaries. Consolidated resolution is important to avoid ring-fencing and country-by-country actions that would aggravate the crisis and damage the internal market. Supervisory action should be triggered by reference to regulatory capital requirements, with a strong presumption to act imposed on supervisors, so as to minimize room for supervisory forbearance.

Third, consolidated resolution requires delegation of supervisory and resolution powers from the supervisors in the countries hosting subsidiaries to the supervisors of the parent company: these powers would be exercised within the Colleges of supervisors set up for each cross-border banking group, which would ensure full exchange of information and coordinated decision-making. The consolidation criteria are straightforward: branches would all be consolidated, as well as subsidiaries that would not be able to stand alone in case of resolution of the parent company. [5]

In order to make group resolution possible, all European banking groups would be required to prepare and regularly update a document detailing the full consolidated structure of legal entities that depend on the parent company for their survival, and a clear description of operational – as distinct from legal – responsibilities and decision-making, notably regarding functions centralized with the parent company. The document should also include contingency plans describing possible recovery and winding-up arrangements, also updated on an ongoing basis, taking account of key factors such as size, interconnectedness, complexity and dependencies. In preparing their plans, banks would be free to decide the structure and organization of their business, notably regarding the decision to set up branches or subsidiaries in the foreign jurisdictions where they operate.

Fourth, the Colleges of supervisors would report to the European Banking Authority (EBA), which would sanction all proposals by the Colleges with its own decisions. These decisions would include the initiation of mandated action and all subsequent steps as well as the mediation of disputes between national supervisors. This adjudication role of EBA is essential to ensure fair treatment of all interested parties in all the jurisdictions involved, and thus legitimize the delegation of supervisory powers. Equally important is the presumption to act when the (consolidated) capital of the parent company falls below certain thresholds, because this provides extra assurance to countries hosting the bank's subsidiaries that supervisory forbearance will not be used to favour national interests in the parent company's jurisdictions, to the detriment of other stakeholders.

Under this scheme, liquidation would commence only after all other remedies have failed. The primary purpose of the liquidation would be to preserve and optimize the residual bank assets for

[5] Separate resolution of subsidiaries, eschewing consolidation in the parent group, would only be allowed to the extent that they would be demonstrably fully independent of the parent company, would be unaffected by its liquidation and would not endanger its survival in case the subsidiary were wound up.

the satisfaction of creditors, and residual claims by shareholders; it would be managed before national courts under existing rules for coordination of jurisdictions. At that point a bridge bank would already have taken over all deposits and other 'sound' banking activities, thus ensuring their continuity. All other assets and liabilities, together with the price received for the transfer of assets to the bridge bank, would remain in the 'residual' bank, which would be stripped of its banking licence. An administrator for the liquidation of the residual bank would be appointed to determine its value and satisfy creditors according to the legal order of priorities, based on the law of the parent company and the other jurisdictions involved.

6. Union bonds

In the discussions of sovereign crisis management within the eurozone, a number of schemes have been proposed to substitute Union bonds for national sovereign debts, with allegedly substantial gains for everyone stemming from credit risk and liquidity enhancement. While the schemes differ as to the purpose, amount and guarantee mechanisms, in all cases the bonds would be issued by a new specialized agency sometimes referred to as European Debt Agency. However, it seems quite obvious that, while an agency would indeed be required for issuing the bonds, in practice any such task could be taken up by the ESM (once of course the member states had agreed on its scope of action); therefore institutional arrangements do not seem important in discriminating between the different schemes and may be disregarded at this stage.

A more relevant distinction is that between the schemes that apply to all eurozone sovereign debt and those specifically targeted at easing the debt burden of distressed sovereign borrowers.[6]

The former schemes envisage a large-scale substitution of national debts with jointly-issued bonds, up to a maximum ratio to GDP corresponding to some acceptable level of indebtedness – e.g. the 60% ratio required by the Maastricht criterion, as in Delpla and von Weiszäcker (2010) and Messori (2011), or lower for extra prudence (e.g. 40% in Monti, 2010b, 50% in Juncker–Tremonti, 2010). In Delpla and von Weiszäcker (2010), all eurozone member states may participate, but some could decide not to do it: therefore, the quality of Union bonds could vary depending on participation. In practice, the scheme could lead to the creation of a Triple A club of Union bond issuers since low-rated sovereign borrowers would in all likelihood not join the scheme for fear of confronting skyrocketing costs on their remaining 'red' national bonds, whose risk of default would in all likelihood increase more than proportionately.

These schemes assume that there are substantial gains to be reaped, in terms of borrowing costs, from the creation of a large and deep market for Union bonds – assuming the Union bonds would always obtain the Triple A rating. The unspoken hope of additional gains from seignorage, like in the US experience, also looms large in the background (but is anathema for German financial probity). The large scale conversion of Union bonds for national bonds could also bring the extra benefit of reducing the risk of a confidence crisis on the weak sovereign debtors spreading by contagion to all eurozone sovereign markets.

On the other hand, while the lowly-rated sovereigns would benefit from a reduction in credit risk, the highly-rated issuers would in all likelihood lose on this score, regardless of whether the bonds were separately guaranteed pro-quota or jointly guaranteed by all eurozone sovereign issuers. Unfortunately, empirical evidence indicates that market spreads over the best (Triple A) paper are in the main determined by credit risks, and that large liquidity gains are simply not there – except for certain small highly-rated issuers or during periods of acute tensions in financial markets (Favero and Missale, 2010).

Moreover, any massive substitutions of Union for national bonds would seem to violate Article 125 of TFEU since the conditions for financial assistance under the Treaty would not be met, and any such operation would amount to some degree to the joint assumption of liabilities for national public debts: certainly so if Union bonds were guaranteed jointly, but in all likelihood also with separate guarantees pro-quota, since a pro-quota default would damage all the member

[6] Union bonds can be used for other Treaty purposes, including financing investment in common projects of European interest, as advocated by Monti (2010a) and President Barroso's "Europe 2020 Project Bond Initiative".

states and the eurozone as an issuer. Favero and Missale (2010) have also pointed out the considerable cost and management difficulties that would need to be overcome to coordinate national debt issues over time and establish a stable and predictable flow of the newly-issued bonds. All in all, political opposition would in all likelihood be insurmountable, since it is utterly unthinkable that German public opinion would ever accept any scheme entailing massive substitution of Union bonds for national bonds, which would inevitably weaken market discipline and enhance moral hazard, and possibly entail German guarantees for periphery government debt (Gros and Mayer, 2011).

Similar difficulties do not arise when Union bonds are issued by Union institutions for specific common purposes stemming from the Treaty or recognized by legislation; in this case the joint guaranty for the bonds is also a direct consequence of the Union legal order. For instance, the European Investment Bank (EIB) issues bonds guaranteed by its capital and ultimately by its members, to finance investment projects of common interest meeting statutory quality requirements. Its bonds clearly fall under the label of "joint execution of a specific project" in Article 125.

The decision to have the new ESM issue Union bonds to provide financial assistance to distressed members of the eurozone may also be seen as a specific project in the sense of Article 125 – although it is preferable to explicitly underpin the legality of such operations by means of an amendment of Article 136, as the Council has decided to do. As has been argued, a joint guarantee on ESM bonds by eurozone member states would not violate Article 125 of the TFEU to the extent that the ESM activities would respect the so-called 'no-bailout' condition: i.e., that the ESM "would not be liable for or assume the commitments" of national public borrowers. This is precisely the case, for instance, with the Gros and Mayer (2011) proposal to open a window at the ESM where creditors may exchange national debt with ESM-issued Union bonds at prevailing market prices.

7. The European Stability Mechanism

We now have all the building blocks required to decide what the ESM should and should not do, consistent with the no-bailout Treaty prohibition but also the need to effectively resolve the debt crisis in the eurozone and restore durable financial stability.

The ESM should be empowered to issue bonds for "the execution of a specific project" as under Article 125 TFEU and/or to grant financial assistance as under new Article 136 TFEU for eurozone member states. Any operation undertaken by the ESM should not result in a fiscal transfer or an assumption of credit risk exposure to the member state concerned, or a guarantee for its liabilities.

Financial assistance to distressed sovereign debtors should go beyond providing temporary liquidity support and be granted for the period necessary to restore debt sustainability and normal access to private capital markets. To this end, adjustment programmes should explicitly assess debt sustainability and financing gaps, and provide a framework for debt restructuring when needed. In practice, when debt sustainability is not assured, the debtor should be encouraged to start negotiations with its creditors on suitable changes in debt terms and conditions, as a preliminary condition for financial assistance and approval of the adjustment programme. Independent assessments by the Commission and the IMF would offer an objective reference for negotiations between the debtor country and its creditors.[7]

The inclusion of debt sustainability among the conditions of financial assistance is key to respecting the no-bailout condition since it will ensure that the ESM will not take upon itself any sovereign debt liability; it will also reduce the probability of financial market turmoil due to weak credibility of adjustment programmes, as has been experienced in the recent past.

However, this standard financial assistance will not suffice, and more will be needed. The ESM should also be entitled to intervene to help the

[7] Axel Weber (2011) has proposed that the maturity of sovereign debt be automatically extended by 3 years for countries applying for aid under the ESM so as to give distressed countries the time to implement the adjustment programme and consolidate public finances. We wonder, however, whether a case-by-case evaluation of debt restructuring would not be preferable in order to ensure that the costs of debt restructuring are minimized and fairly allocated.

member states recapitalize their banking system as required by emerging losses on restructured sovereign debts, keeping in mind that Europe's banking system still is undercapitalized and exposed to new shocks (Gros, 2011).

The feared impact of sovereign debt insolvency on the banking system has indeed been the main channel of contagion in the eurozone financial system: therefore, it is only rational to use the ESM to tame it by offering eurozone member states adequate means to keep their banks well capitalised, should national resources prove inadequate. Of course, this kind of financial assistance should also come under appropriate conditions, placing emphasis on regulatory reform and strengthened prudential rules for banking and financial systems. It could be part of a broader adjustment programme or be granted solely in connection with decisive bank recapitalization.

Finally, as has been suggested by Gros and Mayer (2011), the ESM should be allowed to swap its own liabilities with large volumes of distressed sovereign debt held in private portfolios, at current market valuation – which would be instrumental in facilitating voluntary debt restructuring of countries already under a financial assistance programme. By using the swap technique the transaction would not affect the market price, thus avoiding unwarranted benefits for the debtor.

In all these instances, the ESM holdings of sovereign debt would then be sold back to the debtor under the financial assistance programme framework, so as to ensure that the debtor benefits from the attendant debt reductions, but also that those benefits are strictly used to accelerate return to full debt sustainability.[8] The ESM would remain temporarily exposed to some market risk on its debt holding, but would in no case participate in restructuring losses, which would only be shared by the sovereign debtor and private creditors. Thus, this type of intervention would not amount to a direct extension of credit or guarantee on national debts.

It has been suggested (including by one of these authors) that the ESM should be empowered to purchase distressed sovereign debt in the secondary market so as to relieve the ECB from this type of intervention at times of acute market distress. So far the burden has fallen on the ECB system, which is providing finance to distressed governments and banking systems through national rediscount facilities, lower quality of eligible collateral and market purchases of sovereigns – operations that are not easy to reverse as long as the underlying solvency problem remains unresolved. The longer the ECB is forced to support sovereign debt markets, the higher the risk that its activities will trespass the border of providing inflationary finance to distressed sovereign debtors.

However, the ESM seems ill-suited for undertaking market interventions. Perhaps a better alternative would be to leave these operations in the hands of the ECB but enable the ESM to purchase sovereign paper in the ECB portfolio, at prevailing market prices, when market conditions do not allow the ECB to reverse its purchases in the market. The ECB would no longer be stuck with low-rating government paper, while the ESM would be able to dispose of them within the broader context of the financial assistance programme to that particular sovereign debtor.

One aspect that requires further reflection is the decision by the European Council to grant seniority status to all ESM financing. Our analysis indicates that it is not strictly necessary to respect the no-fiscal-transfer condition, while Gros (2010) has convincingly argued that it will increase the probability of default of all other outstanding debts. Perhaps the Council should reconsider this decision, which may on paper reassure certain domestic public opinion but de facto make the return to overall debt sustainability more difficult.

As has been argued, once the remit of the ESM has been clearly defined so as to exclude any fiscal transfer or guarantee for national sovereign debt, it would logically follow that the ESM's liabilities should be separately and jointly guaranteed by all the eurozone members: this would maximise the gains in credit risk and liquidity for the issuer while not in the least exposing it to any greater sovereign risk.

[8] This is a better alternative to the Brady solution of asking debtors to purchase collateral with additional financial assistance funds.

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