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European Stability Mechanism in the Making

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On March 24, the European Council adopted a decision to amend the treaty in order to create a legal basis for the European Stability Mechanism. Thus began the negotiations of intergovernmental agreement between members of the euro area setting out the details of the structure and tasks of the mechanism. Although it is designed to bring financial stability in the euro area, its initial financing capabilities are limited. Launching the mechanism in 2013, does not solve the key problem, which is the undercapitalized banking sector in Europe.

Background. Fiscal problems in Greece in the first half of 2010, and the real threat to the stability of the other member states resulted in initiating temporary emergency financial assistance, agreed to in May 2010. Due to the uneasy situation on the financial markets and prospects of fiscal problems in subsequent countries (Portugal, Ireland, Italy and Spain), it was decided an acceleration was necessary of the creation of a temporary financial assistance mechanism that would safeguard the integrity of the euro area. On 9 May 2010, the Council for Economic and Financial Affairs agreed on a hybrid financial mechanism consisting of temporary assistance instruments and means of IMF. These actions did not calm the financial markets. Therefore, on 28-29 October 2010, the European Council announced it would create a permanent European Stability Mechanism (ESM), which will replace the existing temporary instruments after June 2013. Creation of the ESM requires a change in the Treaty on the functioning of the EU (TFEU). On 16-17 December 2010, the European Council determined that Article 136 TFEU, which provides that in order to ensure the proper functioning of the Economic and Monetary Union the EU Council adopt measures to strengthen the coordination and supervision of budgetary discipline of the euro area, would be amended.

Revision Procedure of Art. 136 of the TFEU. The revision procedure was formally initiated in December 2010 when the Belgian rotating presidency filed the motion. In order to establish the legal basis for the ESM, the simplified revision procedure provided in Art. 48.6 of the Treaty on the European Union was chosen. It enables a revision of the primary law of the EU without convening a convention, and, hence, without the conference of representatives of the governments of member states. The decision to amend the treaty is adopted unanimously by the European Council after consulting with the European Commission (EC), European Parliament (EP) and the European Central Bank (ECB). Adoption of the EP's resolution of 23 March completed the process of issuing opinions. The simplified revision procedure aims to make the process of approving the decision in each member state more efficient. The application of the simplified revision procedure is limited only to the EU policies and internal actions that would not increase the competences conferred on the EU. This last guarantee may positively influence the European Council decision for approval, especially in those member states whose constitutional systems provide for a national referendum each time the transfer of national competences to the EU level is foreseen. The simplified revision procedure, applied for the first time, limits the participation of the EP to the consultative role. EP's resistance to reduce its importance in the treaty revision may hinder the application of this procedure in the future as a means of further deepening integration.

The ESM Provisions. The main principles of ESM's operation are presented in the attachment to the European Council's spring summit conclusions. Details of this mechanism have been developed by the Eurogroup finance ministers and by the remaining 10 member states. A permanent mechanism will be created by an intergovernmental agreement of the euro area members. ESM will have an effective capacity to provide loans up to €500 billion. Thus, it should protect the stability of the euro area, being an essential element of the EU economic governance. Its reliable, capital structure based on the highest rating (AAA) is an important element of the ESM's effectiveness, which will enable easier asset acquisition on the financial market. It will possess a total subscribed capital of €700 billion, consisting of three types of contributions: paid-up capital, capital on demand and guaranteed capital. They will be determined by the key of contributions to ECB capital. The poorest countries of the euro area will benefit from a rebate. Paid-up capital of €80 billion will be delivered by the euro area members over five consecutive years, beginning from 2013, in instalments. As agreed, the member states from outside the euro area will be able to participate in ESM assistance by providing bilateral loans. Access to ESM assistance will be guarded by strict political conditions, such as the implementation of reform programs and the precise analysis of the debt-servicing capacity. This assessment will be carried out by the EC acting jointly with the IMF, in cooperation with the ECB.

Conclusions. The ESM is a necessary element of the actions undertaken to enhance economic governance in the EU. Regaining the trust of financial markets in the eurozone will depend on the effective implementation of the ESM .

Agreement on the establishment and functioning of the ESM, which is to be adopted by the euro area members, will impose on its parties a number of obligations, in particular in the scope of financial contributions to the ESM. member states that run for the common currency will have to accept the mechanism in the shape eventually noted in the agreement. In practice, it means the establishment of additional financial burdens for those member states that apply for accession to the euro area. Once they are ready to adopt the common currency, they will also have to provide a financial contribution, the amount of which will be indicated on the basis of a paid-up capital key to the ECB, as applied to the current members of the euro area.

Extending at Germany' request the period to pay in capital to the ESM over five years instead of three years as initially foreseen will delay the achievement of its operational capability. In the first year of its functioning, the mechanism will have at its disposal only €16 billion of subscribed capital. The full capital subscription will be achieved no earlier than 2017. It will limit the financing capabilities of the mechanism and may weaken the efficiency of the actions taken in case new fiscal problems appear in the euro area.

It needs to be underlined, though, that the establishment of the ESM does not solve the current key problem preventing the restoration of the full financial stability in the EU—that is the undercapitalization of the European banking sector. From that perspective, publication of the evaluation of second stress tests planned for June 2011 may constitute an important factor speeding up the process of taking other necessary steps that will require strong political coordination on the EU level.

Placing the ESM in the intergovernmental framework and providing limited engagement of the EU institutions in its functioning creates a risk of weakening the coherence of actions undertaken within the EU economic-financial affairs. At the same time, included in the European Council's conclusions of 24-25 March, a declaration to draft EU Regulation concerning the conditionality of activating the financial assistance opens for institutions the possibility to influence the indication of those conditions in the legislative act. Works on the draft regulation, which will be undertaken probably in the second half of 2011, may prove to be a major challenge for the Polish presidency. It will have to seek not only a compromise among the EU Council, but also to coordinate the cooperation over the content of the act between the EU Council and European Parliament.

The process of approving a treaty revision in member states will coincide with the group presidency of Poland-Denmark-Cyprus. Poland, for whom one of the priorities is to act on the further economic governance enhancement, shall expend its care to fulfil that process efficiently. Quick ratification of the treaty revision in Poland itself would positively influence the image of the rotating presidency.