The Greek crisis and the European Stability Mechanism (ESM)

Abstract

The financial crisis of 2007–2008 is considered by many economists to be the worst financial crisis since the Great Depression of the 1930s. It has rapidly spread from the United States' real estate industry to the banking system and it has eventually affected the real economy, both in the United States and in all the Western World.

The effect on European economy has been catastrophic everywhere but above all in weaker economies, such as the Greek one, characterized by the pre-existence of overly high structural deficits and debt-to-GDP levels on public accounts.

In April 2010 Greek government debts were downgraded to junk bond and this led to a crisis of confidence among investors, concerned that Greece was not able to meet its debt obligations. European economies are very interconnected and mutually reliant, above all in the Eurozone, and the Greek default risk was not a possibility.

The European legal framework didn't contain a crisis management mechanism and the EU reacted to the Greek sovereign debt crisis with a mixture of short-term fixes to avoid a breakdown of the single currency and longer-term measures such as the establishment of a banking union to prevent future crisis.

The first step was the signature of the Intercreditor Agreement and the Loan Facility Agreement in 2010, two intergovernmental agreements establishing a credit line for the Greek government, together with a “Memorandum of understanding”, an agreement containing strict economic rules the respect of which is necessary to access the financial assistance. Its total amount was 110 billion euros in three years, 80 billions from European countries and the remaining 30 from the International Monetary Fund, through a Stand-by Arrangement.

Simultaneously Council Regulation 407/2010 which provides for the institution of the European Financial Stabilization Mechanism (EFSM) was approved. Based on the art. 122 TFUE, the ESM is an emergency funding programme reliant upon funds raised on the financial markets and guaranteed by the European Commission using the budget of the European Union as collateral, meaning that there is no debt-servicing cost for the Union. All interest and loan principal is repaid by the beneficiary Member State via the Commission. (60 billion euros). It essentially reproduces for the EU 27 the basic mechanism of the existing Balance of Payments Regulation for non-euro area Member

States, so called Medium Term Financial support, previously used to provide assistance to Hungary, Romania and Latvia in 2009. The EFSM has been activated for Ireland and Portugal, for a total amount up to €48.5 billion (up to €22.5 billion for Ireland and up to €26 billion for Portugal), to be disbursed over 3 years (2011 – 2013).

On June 7 2010 the Ecofin Council instituted the European Financial Stability Facility (EFSF), a temporary rescue mechanism, whose aim is to preserve financial stability in Europe by providing financial assistance to eurozone states in economic difficulty. The EFSF is a *"société anonyme"* based in Luxembourg which issues bonds or other debt instruments on the capital markets. The shareholders are the euro area member states and the facility can borrow up to €440 billion, together with the assistance provided by the EFSM.

The EFSM and the EFSF, the so called facilities, have been used to provide assistance to Ireland and Portugal but their endowment was not sufficient to face the wide financial crisis and the Member States decided the institution of a permanent mechanism. After the modification of the art. 136 TFUE with the addition of a third comma, enabling the member states to establish a permanent crisis resolution mechanism for the countries of the euro area to be used to ensure financial stability, the European states have signed, on February 2nd 2012, the Treaty establishing the European Stability Mechanism. It will assume the tasks currently fulfilled by the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) in providing, where needed, financial assistance to Euro area Member States. The ESM is an international financial institution, subject to international law and based in Luxembourg and it can borrow up to 700 billion euros.

The ESM applies a diversified funding strategy, which entails the use of a variety of instruments and maturities to ensure the efficiency of funding and continuous market access. The institution is led by the Border of Governors, consisting of Ministers of Finance of the member states and the Board of Directors that consists 17 members "of high competence in economic and financial matters". Five different kind of support programmes could be offered and they are first of all the stability support loan within a macro-economic adjustment programme, then the bank recapitalisation programme, the precautionary financial assistance and, last but not least, the primary and secondary Market Support Facility.

All the support programmes require the acceptance of several strict rules, regarding political and economic measures to be adopted by the government to ensure financial stability and responsible administration. They traditionally consist of stronger regulation of fiscal policy, financial sector stability and supervision, fiscal strctural measures, privatisations, public administration and government expenditure and labor market and education reforms. Countermeasures taken by the Greek government involved fighting against corruption and tax evasion, as well as austerity packages and reforms. These rules are established by the Memoranda of understanding, multilateral agreements to be negotiated by the country willing to receive financial support and the so called *“troika”,* a term which comes from the Russian meaning 'group of three', used to define an informal authority of control and decision made by the European Union, represented by the Commission, the European Central Bank and the International Monetary Fund. The troika has played a fundamental role in defining the destiny of countries in fragile economic situations by leading the negotiation of Memoranda and controlling their effective respect. The release of each disbursement to Greece must be approved by both the Eurogroup and the IMF's Executive Board. Prior to this decision, the European Commission, the ECB and the IMF staff conduct joint review missions to the country in order to monitor compliance with the terms and conditions of the Programme.

Financial stability has been a crucial goal for the EU since 1992, when the Treaty of Maastricht was signed and secondary legislation governing the Stability and Growth Pact (SGP) was initially approved in 1997, with significant reforms enacted in 2005 and 2011. Its main aim is to maintain financial stability in the Eurozone and it pursues both a preventive and a corrective policy, with rules trying to avoid financial problems and a corrective mechanism to repair them.

Together with the Memoranda, the symbol of this strict conditionality is the link between the ESM and the he Fiscal Compact, formally the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, also referred to as TSCG or the Fiscal Stability Treaty. It is an intergovernmental agreement signed by 25 EU Member States (all but UK and Czech Republic) on 2 March 2012. It comes after a series of legislative acts willing to improve and reform financial rules, to guarantee more uniformity in the EMU (Economic and Monetary Union). On 3 December 2011 indeed the so called *Six-pack* entered into force. It is made by six legislative bills, five

Regulations and one Directive. The aim is to strength economic and fiscal governance trough the introduction of an early and gradual system of financial sanctions for euro area Member States, and the require of new minimum standards for national budgetary frameworks. Moreover on May 30 2013 the *Two-pack* was established. It follows the path fixed by the previous legislative bills by establishing through two Regulations a comprehensive surveillance regime for those Member States in the euro area threatened with or experiencing serious difficulties with respect to their financial stability.

The Fiscal Compact complements, and in some areas enhances further, key provisions of the Stability and Growth Pact. In particular it requires Member States to introduce in national law (trough a domestic "implementation law" establishing a self-correcting mechanism, at constitutional level when and if possible is preferred) a balanced budget rule with a lower limit of a structural deficit of 0.5% GDP and a correction mechanism in case of deviation.

The whole pattern is designed to guarantee financial stability and a strong and reliable currency. Despite all these efforts the recovery from the terrible 2008 sovereign debt crisis has been very slow and it is still ongoing. There are several and complex reasons for that, including structural problems that cannot be discussed easily but one of the crucial factor is the asymmetry between monetary and economic policy. The monetary authority for the Euro area is indeed the European Central Bank, fixing the same rules for all the countries. The political economy choices still belong to national governments, since they imply redistributive effects and, as a consequence, they require democratic consensus. The democratic gap affecting EU at its origins has been now overcome, the European parliament is democratically elected from 1979 and the co-decision method is widely used to establish laws, but in macroeconomic choices there is still a lack of legitimacy.

The lack of democratic consensus in macroeconomic choices has led to two main legal challenges to the MES. The first one is a motion to the German Federal Constitutional Court in Karlsruhe, willing to stop the ESM from being approved by Germany. The Court has rejected the motion while ruling Germany’s 190 billion-euro contribution can’t be increased without legislative approval. The court said Germany can ratify the ESM if it includes that it won’t be forced to assume higher liabilities without its consent.

The second main challenge come from Ireland, in particular from a member of parliament, Thomas Pringle. He objects to Ireland's participation in the ESM Treaty and its proposed ratification. At the start of his litigation in the Irish High Court he made five claims against the Government of Ireland, Ireland and the Attorney General, regarding incompatibility with the provisions in the TEU, and the TFEU concerning Economic and Monetary Policy, obligations which encroached on the exclusive competences of the Union in the matter of the euro and related policies. Also he notices that the Decision adopted alters the competences of the Union contrary to the third paragraph of Article 48(6) TEU, which states: 'The decision […] shall not increase the competences conferred on the Union in the Treaties'.

The Irish Court has made request for a preliminary ruling decision to the European Court of Justice which has rejected both the objection, legitimating the ESM.

Despite this legitimacy and the aids provided by the Mechanism, the recovery path is still long and some problems are still unresolved.

To enhance the economic governance in the Eurozone and strengthen financial stability Europe 2020, the European strategy for growth in the incoming decade, has been approved in 2010. Its main goal is to make the EU a smart, sustainable and inclusive economy, trough reforms in labour market, sustainability and social cohesion. It also contain the prevision for an European Semester to better coordinate national economic policies.

An ongoing, ambitious and very effective project is a banking union for the euro area (non euro members can join as well by signing an agreement with the ECB). It consists of a Single Supervisory Mechanism, already established and to be effective form November 2014, and a Single Resolution Mechanism for banks, whose purpose is to ensure an orderly resolution of failing banks with minimal costs for taxpayers and to the real economy, in sharp contrast with what happened in 2008.

The banking union is a very strong and powerful sign, showing that Europe is recovering from crisis and it is determined to improve and enhance the integration among member states. However the powers ECB will gain during the next month should be balanced with more transparency and more democratic influence on it.

The two main goals for EU to be achieved in order to preserve Stability from economic and political crisis are deeper democratic control and deeper economic governance, both crucial to create a safer and sounder not only economic but general environment and to make European Union stronger to its citizens and to the rest of the world.