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# Financial Stability & Solidarity: the evolution of the European Stability Mechanism from the Financial Crisis to the challenges ahead for the Euro Area


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# The European Symphony

When Ludwig Van Beethoven wrote its Symphony No. 9 in D Minor in the 1820s, Europe was experiencing the effort by Absolute Monarchies to restore the pre-revolutionary status quo and to eliminate any republican, liberal and revolutionary movement. More than a century later, after two World Wars, the Ode to Joy was chosen as the Official Anthem of the European Union

*1 - The Beginning of the Second Movement - Allegro Molto Vivace - of Ludwig Van Beethoven's Symphony N. 9 in D Minor - Original Manuscript*

The second movement of the Symphony is my favourite as it manages to describe humans' contradictions and conflicts from a harmonious perspective by only using the dialogue of musical instruments. The beginning is a rapid and almost violent

exchange between arches and drums. Soon later, all the instruments of the Orchestra start to play their melody, they start debating and discussing, each of them plays a different part with different intensity and sensibility, each musician with a different history, a different background, a different culture. The result of this apparent chaos is however pure harmony, power, energy, happiness, joy.

Personally, I try to imagine the European Union the same way. A symphony of millions of people from different countries and cultures, speaking different languages, with different opinions and sensibilities, different interests, different personal histories. After centuries of wars and conflicts, after the horror of two World Wars, millions of European citizens had the courage to build together an orchestra and to play a new Symphony with a spirit of brotherhood and joy. The resulted European Union will never be as perfect as Beethoven's Symphonies or Mozart's piano Concertos but it certainly is an extraordinary example of what we can achieve as humans when we fight together for something greater than our personal or national interests and to build a better future for the next generation.

The history of the European Stability Mechanism, before its technicalities and specificities, is the history of men and women which, in a period unprecedented crisis, have worked together to find a solution with the aim of both addressing the financial crisis and guaranteeing a better future for the Union. During this process there have been great clashes, conflicts and arguments among national leaders and politicians, among economists and academics, but the final result was the first European institution to share great financial resources among members states in a spirit of solidarity.

Just like in an orchestra, the chaotic union of thousands of people, views and opinions, have finally resulted in a harmonious result which, unlike Beethoven's symphonies, will always offer space for improvements to face the challenges ahead.

# Introduction

## *Financial Stability and the European Stability Mechanism*

Financial Stability is the basis on which the entire Euro System was built and it is the cardinal principle on which Euro Area financial institution have their foundation. The creation of the Euro currency itself started with the effort to build stability of public finances and currencies of the initial 11 member states. The Maastricht criteria were indeed designed to guarantee convergence in areas which were strongly related to general financial stability, from sustainable public finances to interest rates and national currencies' exchange rates. The Maastricht Convergence criteria had to guarantee that future Euro-area Member States would have shown stability both in the short and in the long term.

In the original project of the Euro System, the European Central Bank was designed to be the guardian of financial stability of the Euro Area in cooperation with national central banks. Still today the primary objective of the ECB is to maintain price stability through a level of inflation (2% over the medium term) which remains low, stable and predictable.

Nevertheless, the financial crisis has shown the weaknesses of the Euro System especially in relation with the lack of specific instruments designed to cope with unexpected crisis and dangerous spillover effects. The financial crisis has indeed been a crucial moment in Europe's history as it has shown the weaknesses of the Euro system and has forced all institutions and member states to cooperate to both face the crisis and guarantee that in the future such crisis could not happen anymore.

The European Stability Mechanism was created in this context in the effort to both have the necessary funds to finance stability programmes and avoid panic on financial markets and also to define specific and effective mechanisms to help the receiving country to exit from the crisis and return to sustainable economic growth. Since its first creation as European Financial Stability Facility, the ESM has played a pivotal role

during the years of the financial crisis after the failure of the first Greek bailout and has guaranteed to Euro-Area countries more autonomy from International Financial Institutions such as the IMF in crisis management.

The aim of this thesis is to offer a broad perspective over the creation of the ESM and its role during the last decade as the guardian of financial stability and as lender of last resort in case of a major financial crisis. The first chapter will be focused on the past of the ESM, from its creation to its last adjustment programme in Spain. In the description, specific focus will be given to the role of public opinion and how mistakes were made not only on a technical point of view, but also from a political point of view as many of the consequences of the financial crisis still influence today's debate on EU's economic policies and financial regulations.

The second Chapter will be focused on the present of the ESM and its more recent developments from the Pandemic Crisis Emergency Support to the reform and its ratification. In the second Chapter there will be a further analysis dedicated to Italy as both the only country which, despite its precarious economic condition, did not enter into and adjustment programme and as a great debate over the ESM has developed in the last two years both around the activation of the Pandemic Line and on the ratification of the treaty reform.

Finally, the last chapter, will be focused on the future of the ESM in relation to the challenges that will have to be addressed and which will endanger financial stability, from climate change to geopolitical tensions. The proposal for the creation of a European Monetary Fund will be evaluated together with the potential obstacles which may be encountered in the effort to reform the instrument and to further increase its capacity and efficiency. Conclusions will be drawn to give an overall evaluation of the instrument given the past experiences and interventions and its future perspectives, to also understand the political importance of its creation beyond the purely technical and practical needs related to the financial crisis.

# Chapter I – The Past

## 1) The Greek Financial Crisis & the Naissance of the European Financial Stability Facility

### *The beginning of the Crisis*

When, on 4th October 2009, the socialist Giōrgos Papandreou was elected prime Minister of Greece, he probably did not expect having to face the most dramatic economic crisis ever experienced by a member of the European Union and to take the responsibility for the lies of his predecessors. Papandreou came from a well-known family of Greek politicians: his grandfather was the exiled head of the Greek government during the WWII occupation by Italy and Germany, his father had been Prime Minister from 1981 to 1988 after founding the Socialist Party "PASOK" in 1974 right after the end of the Regime of the Colonels[1].

The Previous Government held by Kōstas Karamanlis had been lying on the actual situation of Public Finances which were far from respecting the clauses of the Stability & Growth Pact and, most likely, when the newly elected Prime Minister was made aware of the status of the Deficit to GDP he realised that another Papandreou was to be a Protagonist in a dramatic moment in the history of Greece.

Greek budget deficit in 2009 was to be ten percentage points higher than previously stated (Official Initial Prevision by Karamanlis was 3,7%, then raised to 12,2% and finally resulted to be 15,2%)[2] and, behind this single data, there was the highest public debt in Europe and completely unsustainable public sector expenses: public debt was 117.6% of GDP (the highest in Europe), Greek/German bond yield spread reached

[1] Hatzis, Aristides N., A Political History of Modern Greece, 1821–2018 (2019). In: Marciano, A., Ramello, G.B. (eds) Encyclopedia of Law and Economics. Springer, New York, NY, 2019.

[2] Eurostat - Government finance statistics - Statistics Explained (europa.eu),
Tony Barber (2010): Greece Condemned for falsifying Data. Financial Times (ft.com)

700 bps, pension expenditure increase between 1991 and 2009 averaged 8.3% annually & wages in the public sector were almost 30% higher than in the private. [3]

As a consequence, in the context of the 2008 financial crisis where the S&P 500 at the NYSE lost around 50% of its value, rating agencies started to downgrade Greece's credit rating. The first agency to move was Fitch, which in the month of October downgraded Greece from A to A- and no more than 40 days later went from A- to BBB+ (one level above the "non-investment grade"). Within 15 days, in the month of December, Standard & Poor's downgraded from A- to BBB- and Moody's went from A1 to A2. [4]

Within six months the yield spreads between Greek and benchmark German 10-years bunds almost doubled, Athens's stock market lost almost 2/3 of its value with all the major banks suffering important losses[5]. At the beginning of 2010 Papandreou announced two austerity packages and in April 2010 formally requested an international Bailout for Greece. The first Bailout Package with 80 billion Euros of bilateral loans and 30 billion from the IMF over 3 years was agreed on 2nd of May 2010 after a hard debate between sceptical European Countries, especially Germany, concerned of the risk of moral hazard lead by a bailout. The Troika was created with the participation of the IMF lending 30 billion, the European Commission and the European Central Bank monitoring the implementation of the Adjustment Programme.

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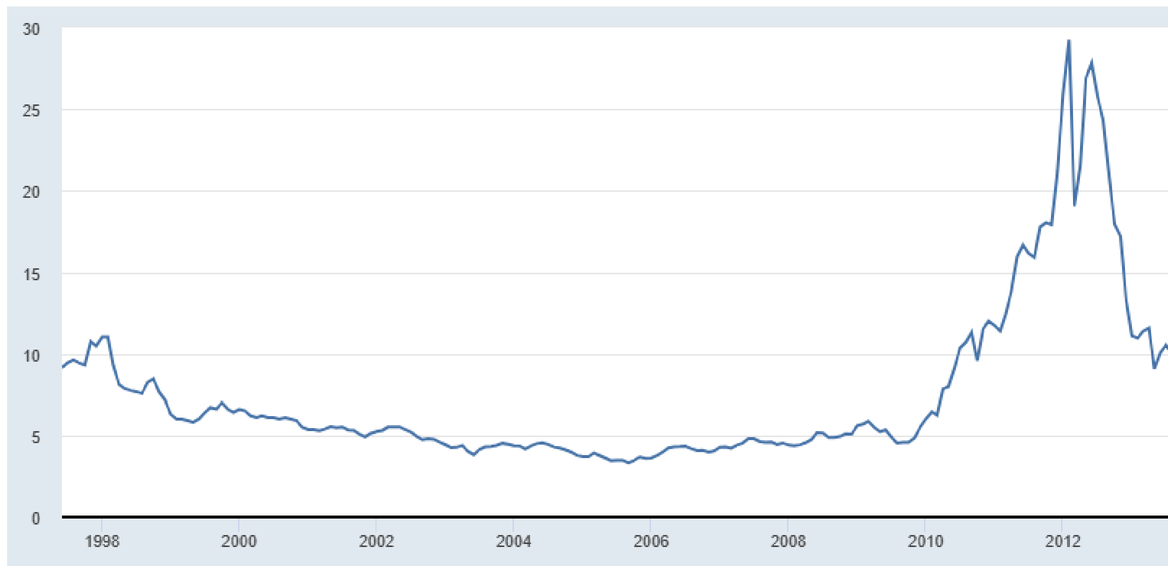
[3] Platon Monokroussos, 2017, "Greece Expenditure on Social Protection and Pensions", Eurobank, ise.ac.uk

[4] Fitch Greek Ratings (fitchratings.com), Moody's Greece Credit Ratings (Moodys.com), S&P Global Ratings (spglobal.com)

[5] Athex Group (Athens Exchange Group), Financial Times-Athens Composite Index (ft.com)

*Figure 1: Long Term Government Bond Yields for Greece (OECD.org)*




Despite the initial ambitiousness of promised structural reforms, austerity measures and fiscal consolidation, after less than 2 years another program was necessary. The second bailout had a great difference compared to the first program. While the first bailout was made by bilateral loans, the second bailout was financed by a new "special purposed vehicle" financed by members of the Eurozone, created in 2010 and firstly used by Ireland and Portugal: The European Financial Stability Facility.

***The Political Dilemma: To save or not to save?***

*2010: an innovative approach is needed*

The 2010 Greek sovereign crisis marked a turning point in Europe's economic policy. The debate in the Council of Economic & Financial Affairs (Ecofin) and the European Council remained on the front pages of newspapers for several months, especially with Germany who initially strongly defended the principle of the "no bailout clause" fearing a spillover effect among other EU countries by incentivizing moral hazard. Germany's initial scepticism and fierce internal debate caused great difficulties for the

Chancellor Angela Merkel contributing to a delayed response in the bailout decision which increased the cost of the intervention. [6] [7] [8]

The fundamental reason why, even today, the Greek crisis is still being studied and analysed is contained in the debate and the policies this event has triggered. For the first time, the stringent rules imposed by the Monetary Union and the Stability & Growth Pact since the 1990s were put to the test in a time of crisis and immediately showed their limits when faced with an unprecedented context. The 'No Bail Out Clause' imposed by Art. 125 of the Treaty on the Functioning of the European Union, although fundamental for the creation of the EMU as a guarantee on the behaviour of *less virtuous* member states in terms of budgetary policies, was the first obstacle to overcome. The absence of a common instrument or institution to face the potential default of Greece's economy prevented an immediate response to the crisis, delegating the decision to the 16 governments of the Euro Area which had to find a complex agreement with Greece while justifying their positions domestically in front of their electorate. While EU member states and the ECOFIN were discussing potential solutions to the crisis, the delayed response undoubtedly increased the costs of the Greek Bailout due to increasing Interests rates and lack of trust within financial markets which for many months were left in uncertainty waiting for an agreement.[9] [10]

An agreement of enormous complexity as EU governments were starting from historically different positions, especially in the area of monetary policy, and as the

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[6] Kutter, Amelie. "A Catalytic Moment: The Greek Crisis in the German Financial Press." Discourse & Society 25, no. 4 (2014): 446–66. http://www.jstor.org/stable/24441595.

[7] Featherstone, K. (2011) "The Greek Sovereign Debt Crisis and EMU: A Failing State in a Skewed Regime". In JCMS: Journal of Common Market Studies (Vol. 49, Issue 2, pp. 193–217). Wiley. https://doi.org/10.1111/j.1468-5965.2010.02139.x

[8] Ardagna, Silvia, and Francesco Caselli. "The Political Economy of the Greek Debt Crisis: A Tale of Two Bailouts." American Economic Journal: Macroeconomics, vol. 6, no. 4, 2014, pp. 291–323. JSTOR, http://www.jstor.org/stable/43189946

[9] Amy Verdun (2015) "A historical institutionalist explanation of the EU's responses to the euro area financial crisis", Journal of European Public Policy, 22:2, 219-237, DOI: 10.1080/13501763.2014.994023

[10] Peel, Quentin (2010) "Germany: Merkel's moment", Financial Times (ft.com)

governments themselves had to face a fierce domestic public opinion, principally in the most relevant country in this policy area: Germany.

Romano Prodi himself, President of the Council of Ministers between 1996 and 1998 during the negotiations for Italy's entry into the Euro, often criticised Angela Merkel's refusal to grant immediate aid to Greece, arguing that the main driver for this decision were the elections in the North Rhein- Westfalia lander as CDU feared losing votes by confronting a public opinion that was highly sceptical of Greece and critical of responsibility for the Mediterranean country's financial situation.[11]

Starting from February 2010, the German Tabloid BILD (the most popular newspaper in Germany) started an editorial campaign strongly criticising Greece, underlining its irresponsibility in managing public finances taking advantage of the stability of the new Euro currency. This narrative, then widely adopted by other Media companies all over Europe, had a great impact over the debate on monetary policies for many years and the public opinion in Germany stopped for several, decisive weeks, agreement by Germany to take decisive countermeasures to tackle the Greek Crisis. A discourse analysis on the German press carried out by Amelie Kutter[12] in relation to that period and how *Crisis Narratives* may have shaped the overall debate on how the crisis should have been dealt with, has shown the potential consequences of a specific political discourse. As Kutter explains, many influential newspapers focused almost entirely on the blame of the crisis rather on the solutions, creating the narrative of Greece as a Southern Country guilty of nefarious political choices, reckless public spending and of guaranteeing unsustainable privileges to its citizen. In addition, Greece could behave in such way thanks to the "protection" and guarantees given by the membership in the Monetary Union and the *integrity & trustworthiness* of Northern European Countries.

[11] Prodi, Romano (2010) "L'Euro e la Germania, la maestra severa che non aiuta l'Europa", article from 28 November 2010. This opinion has been often repeated by Romano Prodi in both TV-interviews and on its personal blog "romanoprodi.it". The role of the German regional elections in delaying Germany's policy intervention has been often subject to political debate and attention in the analysis of the European Sovereign Debt crisis.

[12] Kutter (2014)

Kachelmanns Ex-Geliebte packt aus!

Bild

25000000000 Euro!

Griechen wollen noch mehr Milliarden von uns!

*Figure 2: Bild from 29 April 2010 - 25 000 000 000 Euros! Greeks want even more billions from us!*

Even if the responsibilities of Greek governments and their policies were clear and widely recognised as the main driver of the economic meltdown, the 2010 crisis did not leave any space for solutions other than a bailout. No matter how rightful and legitimate the principles of economic sobriety and discipline over public spending, the risk of a spillover effect brought by a default of Greece both over sovereign debts of other Southern European countries and on the entire European banking system were too high. Euro area banks were exposed for up to €128 billion to Greece in 2008 and a default would have meant potential insolvency for several banks, especially in France and Germany.[13] France even proposed a EU-level crisis management by the ECB and EU budget, including non-Euro area countries, to face the crisis but the proposal was immediately rejected by the UK government. Germany too was in a peculiar situation as, despite a fierce internal public opinion against the Greek bailout, could not afford a potential default as its banking system may have collapsed with billions of Germans' people savings being lost.

[13] 4 P. R. Lane (2012) "The European Sovereign Debt Crisis", Journal of Economic Perspectives, Volume 26, Number 3

*Too Big to Fail*

Once it became clear that a bailout program was inevitable, the debate between the Eurozone states had to focus on striking a balance between the no-bail-out clause contained in the TFEU[14] and the need for solidarity to save Greece's economy and future.

To be accepted, the adjustment program had to eliminate any incentive for moral hazard, both from Greece and any other country which could have found itself in a similar situation. Germany was the first in line to be concerned about Moral Hazard asking for strong guarantees and conditionalities in order to approve the First Adjustment Program. When in March 2010 the leaders of the Euro Area started the discussion about how to intervene, Germany was the country defining the rules of the game and the one Greece had to convince the most in order to get the necessary resources to be saved. As previously mentioned, German domestic opinion was not in favour of a bailout considering how the Greek Government manipulated budget deficits to avoid the obligations imposed by the Stability & Growth Pact. Germany's initial position was therefore to completely avoid using taxpayers' money to resolve the crisis and instead to impose austerity measures and ask for the intervention of multilateral institutions such as the IMF.

Wolfgang Schäuble made it clear during his speech before the vote on the Bailout that the main reason behind the decision to bailout Greece was a cost benefit analysis, without solidarity being a main driver to save Greece: *"Any other alternative would be much more expensive for the German state, it would be much more dangerous, it would take up many more risks"*[15] [16]

The final outcome of the negotiations among Member States was the First Adjustment Program, consisting of 110 billion of bilateral loans from Euro Area States and, as

[14] Art. 125 TFEU - EUR-Lex - 12016E125 - EN - EUR-Lex (europa.eu)

[15] Wearden, G. (2010) 'Europe's financial crisis: as it happened', The Guardian, 28 April

[16] Darren J. Lim, Michalis Moutselos & Michael McKenna (2019) Puzzled out? The unsurprising outcomes of the Greek bailout negotiations, Journal of European Public Policy, 26:3, 325-343, DOI: 10.1080/13501763.2018.1450890

requested by Germany, a contribution of 30 billion from the International Monetary Fund. The granting of these loans was however subject to very strong conditionalities imposed by creditors through the signature of the Memorandum of Understanding.

With the Memorandum of Understanding, the Greek Government agreed to implement several measures in order both to consolidate public finances with fiscal austerity and to approve reforms which could have improved the efficiency of the country with a medium-term perspective. As for fiscal Consolidation, the Memorandum of Understanding imposed strongly ambitious targets: a reduction of the deficit of 11 percentage points within 2014 (from 15% to 3%), cut in public employees' wages from 15 to 30%, laying off 150.000 civil servants (21% of total public employees), 30 billion euro of fiscal cuts (more than 10% of total GDP in 2010 – Data World Bank). As for Reforms, the Memorandum required fostering GDP growth through reforming the labour market, public administration, tax system (addressing tax evasion which was at the highest level in Europe, averaging 30% of the GDP between 1999 and 2007 and still as high as 25% in 2009).[17] [18] [19]

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[17] European Commission (2010), "The Economic Adjustment Programme for Greece", Directorate General for Economic and Financial Affairs" (europa.eu)

[18] Eurostat, Tax Revenue Statistics – Greece (europa.eu)

[19] Schneider, Friedrich (2009) The Shadow Economy in Europe – Data estimates based on 21 OECD countries in 2009.

***The failure of the First Adjustment Program and the Raising Unpopularity of EU financial Institutions***

On March 1st, 2012, less than two years after the first adjustment program, the Greek government lead by the prime minister Lucas Papademos signed the second Economic Adjustment Program. The First Adjustment Program had failed not only on the technical economic aspects but also in creating a positive and cooperative environment where solidarity appeared as the main driver motivating the interventions.[20] [21]

Economists have largely assessed and evaluated the First Adjustment Program trying to understand the reasons behind its failure in order to avoid similar outcomes in the future. The indecision of European Policy Makers leading to a delayed debt restructuring had a negative effect on the behaviour of financial markets which, for several months, were left in a state of high uncertainty and instability, deteriorating even further the status of Greece's public finances. The implementation of the Programme was delayed by the inefficiencies of the Greek government structure which was initially overrated in its administrative capacity by the Troika, which then adopted more strict controlling procedures over its implementation. The programme itself turned out to be too ambitious considering both the domestic Greek situation and the adverse macroeconomic environment at international level. Finally, the most controversial aspect of the Adjustment Programme, which then became the focus of the public debate, was the complex relationship between economic growth & austerity: Greece, unlike other countries who entered the adjustment programmes in the same period, did not manage to boost exports through price competitiveness gained with the austerity programmes failing to implement effective structural reforms.[22]

Another area in which the First Adjustment Programme failed is instead more closely related to how politically this crisis was managed by foreign governments and institutions. A hostile environment against externally imposed economic measures,

[20] Kutter, (2014)

[21] European Commission, Directorate-General for Economic and Financial Affairs, The Second Economic Adjustment Programme for Greece, Brussels, Occasional Papers No. 94, March 2012, 47

[22] Daniel Gros (2015) "Why Greece is Different", ProjectSyndicate.org, May 13

brought public opinion in Greece and other EU countries to develop a great scepticism against Europe's economic policy and the apparent dominance of Germany in imposing austerity on countries suffering from an unprecedented economic crisis.

Instead of aiming at creating a cooperative environment, necessary to implement structural measures, European Institutions appeared as external actors imposing their presence and influence on member states. This factor offered great spaces for blaming the effect of the crisis on imposed austerity and to start a transition towards Eurosceptic positions. Before the financial crisis, Greece experienced decades of strong economic growth and national pride which culminated with the Olympic Games of 2004. The first adjustment programme marked an historic turnaround in living standards and the consequent narrative of the crisis, rather than concentrating on the clear responsibilities of reckless public spending, shifted the blame towards European Institutions and their adjustment programme. The delayed response in the first months of 2010 due to the debate within the ECOFIN and between National Governments, lacking a common instrument such as the ESM which could have guaranteed an immediate and effective response, was perceived as a lack of spirit of solidarity towards a country which was risking a default and an exit from the Euro Area. Millions of European citizens followed for many years the Greek crisis on TV, Newspapers and the New Social Networks, particularly in Southern European Countries which also were facing financial instability fearing they could have found themselves in a similar situation.

The Troika rapidly became public enemy number one, perceived as an unlawful bureaucratic inhumane being imposing austerity and destroying Greece's wealth and dignity. Syntagma square slowly entered in the houses of millions of European citizens appearing on daily news, showing the apparently reasonable protests of thousands of citizens asking for jobs, food and basic services. The images of people forced to live on the street of Athens and long queues in front of Pharmacies to buy prescription drugs marked a dark moment in EU's history. The hatred against institutions and adjustment programmes increased over the years, culminating in 2015 when the result

of a referendum substantially eliminated the results gained in more than four years of sacrifices and fiscal adjustment in no more than 14 days[23].

A crisis which was unquestionably largely caused by national governments' irresponsibility, fell on the shoulders of the institutions and individuals which avoided the risk of a Grexit and Greece's default. The Troika, the European Commission, The European Central Bank, German politicians & *Technocrats* appeared guilty of the Greek disaster in front of millions of citizens, with negative consequences for more than a decade, starting from the necessity of a second and third bailout for Athens.[24] [25]

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[23] Nikolaos Zahariadis (2017) Bargaining power and negotiation strategy: examining the Greek bailouts, 2010–2015, Journal of European Public Policy, 24:5, 675-694, DOI: 10.1080/13501763.2016.1154977

[24] Jean Pisani-Ferry, André Sapir and Guntram Wolf (2013) "EU-IMF assistance to euro-area countries: an early assessment", Bruegel.org

[25] Sapir, Wolff, de Sousa, Terzi (2014) "The Troika and financial assistance in the euro area: successes and failures", Study on the request of the Economic and Monetary Affairs Committee of the European Parliament, europarl.europa.eu

## 2) A Star Is Born: The EFSF, Ireland & Portugal

***The Need for a Stable Instrument***

During the first months of 2010 it was already clear that Greece was not the only country at risk due to its poor public finances and high public debt. For instance, the Portuguese President of the EU Commission José Barroso was knowingly concerned about the potential fall-out of Portugal's debt and financial market[26] [27]. A structural solution was needed in order to avoid delayed (and more costly) interventions and panic on the financial markets in case of a situation of crisis with sharp rises of interest rates. One more issue which led Euro Countries to find a structural and stable solution to reassure the markets was related to a potential distortion which could appear in a single currency system: the risk of a spillover effect for interest rates in case of a threat of insolvency of a single member state. In such a case, even a country with sustainable public finances could have experienced a sharp rise in interest rates encountering problems in servicing their own sovereign debt. Finally, another element of spillover-risk given by the threat of insolvency included the banking sector, already in great difficulty after the 2008 Financial Crisis: European Banks were largely exposed with government bonds and a sharp increase in bond yields due to insolvency could have brought bankruptcy of many banks and jeopardized saving of millions of EU citizens.

This peculiar context therefore required a strong policy response which had to strike the balance between the need to reassure financial markets and eliminate the risk of Moral Hazard among member states. In just three years EU institutions took radical measures which were unthinkable before the crisis, from the Banking Union[28] to the OMT (Outright Monetary Transactions)[29] by the ECB, Quantitative Easing and the new European Financial Stability Facility.

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[26] Barber, Tony (2010) "Eurozone to hold emergency Greece talks", Financial Times (ft.com), April 30

[27] Mallet, Victor (2010) "Eurozone inches closer to finalising Greek rescue", Financial Times (ft.com), April 16

[28] European Commission, "The Banking Union", finance.ec.europa.eu

[29] ECB (2012) "Technical Features of Outright Monetary Transactions"

The main obstacle for the creation of the EFSF was its compatibility with the conflicting principle of solidarity and the *no-bailout clause* included in Art 125 of TFEU:[30]

*"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."*

The final decision was therefore to establish the EFSF outside the EU legal framework & treaties as a private company owned by the states of the Eurozone and to establish the EFSM (European Financial Stabilisation Mechanism - Council Regulation (EU) 407/2010)[31] using Art. 122 (2) of the TFEU[32] as a legal basis as it foresees *"possibility of granting Union financial assistance to a Member State in difficulties or seriously threatened with severe difficulties caused by exceptional occurrences beyond its control." (407/2010 par. 1).* For the first time in Europe's history, a group of states agreed on creating a Common instrument sharing the risks and national resources to guarantee stability and trust on financial markets and enhancing the principle of solidarity also in the area of Monetary and Budgetary policies.

[30] Featherstone, K. (2011). The JCMS Annual Lecture: The Greek Sovereign Debt Crisis and EMU: A Failing State in a Skewed Regime*. In JCMS: Journal of Common Market Studies (Vol. 49, Issue 2, pp. 193–217). Wiley. https://doi.org/10.1111/j.1468-5965.2010.02139.x

[31] Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism

[32] Art. 122(2) TFEU: "…*the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken"*

***The European Financial Stability Facility***[33]

No more than a week after the signature of the first Greek memorandum of understanding, regulation 407/2010 of 11th May 2010 established the European Financial Stabilisation Mechanism, an instrument guaranteed & supervised by the EU Commission, using the EU budget as a collateral, and with the authority to raise up to 60 billion euros with a AAA rating by all three rating agencies. One month later, on 7 June 2010, 17 euro-area (initially 16, Estonia joined the treaty in 2011) countries signed the EFSF Framework Agreement establishing the European Financial Stability Facility, a "Société Anonyme" incorporated in Luxembourg. The new facility would have provided financial support to euro-area Member States in conjunction with the IMF on comparable terms to the stability support loans advanced by euro area Member States to the Hellenic Republic on May 8th, 2010. Also considering the contribution by the IMF of € 250 billion, the European safety net reached a total amount of € 750 billion.

The EFSF was authorised to borrow up to € 440 billion after a support request would have been made by a eurozone member which, in order to access the funds, had to negotiate a Memorandum of Understanding with the EU Commission then to be unanimously approved by the Euro Group. Each country would have provided capital guarantees based on ECB's capital key weightings: as a consequence of this criteria, Germany became the largest contributor with 119.3 billion (27,13% of the total), followed by France (20,38%) & Italy (17,91%). The EFSF was initially designed as a temporary instrument with a time horizon of three years. The innovative aspect of the Facility was the shared responsibility it had introduced among member states in case of request of support, which through the issue of AAA financial bonds would have

[33] EFSF Framework Agreement (2010) - EFSF FRAMEWORK AGREEMENT (as amended with effect from the Effective Date of the Amendments) (europa.eu)

increased the public debt of the other member states who had signed the treaty which guaranteed for the new issued debt.[34] [35]

The introduction of shared responsibility was a great step forward in European Economic Policy considering the complex political context emerged during the Greek Crisis and the hard position of Germany on bailouts and the strong internal political debate. Not only was the EFSF a completely new instrument matching the principles of solidarity and the no-bail-out clause[36], but it also opened to a new era of non-conventional economic & monetary policies showing that, in case of need, Euro Area Member States were able to overcome their distances and would have taken extraordinary measures. This was also a very important signal to financial markets who were reassured on the willingness of EU financial institutions to take extraordinary measures in extraordinary circumstances. As Draghi's "whatever it takes" would have shown few years later, Financial Markets were looking for signals demonstrating that EU institutions were able to overcome internal distances in order to guarantee financial stability and the EFSF would have had positive effects even if not used by a euro-area member state as its own existence was already a great guarantee over the solvency of national public debts.

In addition, unlike the IMF, the EFSF did not have the status of preferred creditor in order to avoid excessive distortions in the market and creating disincentives for private investors to re-start investing in countries which were involved in a support programme.

The EFSF was amended twice in the year 2011 both to increase the total lending capacity to € 780 billion and to extend its flexibility & scope of action. Following the amended Treaty, the Financial Assistance to a euro-area Member State allowed both to purchase Bonds on the primary and secondary markets (Security Markets Programme) to "avoid contagion, on the basis of an ECB analysis recognising the

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[34] Credit Suisse (2011) "EFSF (R)evolution, An analysis of the developing infrastructure of the EFSF and ESM"

[35] Closa, C., & Maatsch, A. (2014). In a Spirit of Solidarity? Justifying the European Financial Stability Facility (EFSF) in National Parliamentary Debates. In JCMS: Journal of Common Market Studies (Vol. 52, Issue 4, pp. 826–842). Wiley. https://doi.org/10.1111/jcms.12119

[36] Featherstone (2011)

exceptional financial market circumstances and risks to financial stability and with mutual agreement of EFSF member states"[37]. Specific aspects of Financial Assistance such as Interest Rates & Terms of the debt contract would have been each time negotiated with the member state requesting for assistance.

The Governance of the EFSF, included the German Klaus Regling Chief Executive Officer, later confirmed as Managing Director of the ESM, and a board composed of High Representatives of eurozone member states including Deputy Ministers, Directors Generals of the Treasury & Secretaries of State, reflecting the intergovernmental nature of the new facility. The Board included an observer of the European Commission and European Central Bank. The EFSF, in the context of the 8-9th May Ecofin, was one of the first steps to reform EU's economic governance and a fundamental starting point to change the overall approach of EU institutions towards economic & monetary policies.

### *The EFSF in practice: Portugal, Ireland & The 2nd & 3rd Greek Bailout*

The first country to formally request financial support from the European Financial Stability Facility on 21 November 2010 was the Republic of Ireland, after a period of almost 20 years of strong economic growth referred as the years of the "Celtic Tiger" in which Real GDP almost quintuplicated[38]. The favourable policies of Irish governments to attract foreign investments including low corporate taxes with a consequent growth of many economic sector, especially Real Estate, created a property bubble[39] which during the 2008 crisis severely endangered Ireland's economy and Irish banks which were largely exposed in the sector. In 2008 The Irish government initially tried to manage the Bank crisis without external help, by offering a 2-year unlimited

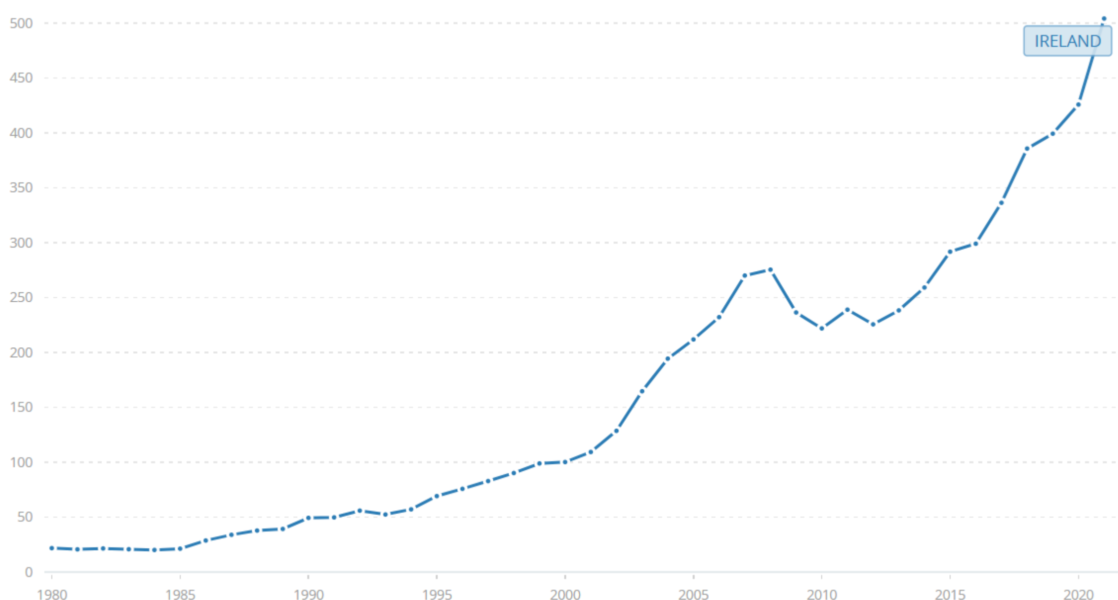
[37] EFSF Framework Agreement, Art. 2 (Financial Assistance)
[38] World Bank – Ireland – World Bank Data

[39] Mentioned also in the ESM website Ireland | European Stability Mechanism (europa.eu)

guarantee of all debts[40] covering liabilities for a total of € 485 billion[41]. However, the financial crisis immediately had effect on the real economy with a sharp decline of GDP & unemployment rise, limiting the effectiveness of the measures undertaken by the Irish Government. Irish Public debt increased with rising yields and interest rates and Ireland was eventually obliged to ask for a financial assistance package[42].

The assistance package included[43] an € 85 billion rescue deal granted by the IMF (22.5 billion), bilateral loans & Irish National Pension Fund (22,3 billion),[44] by the new EFSF (17.7 billion) & by the EU Commission with the EFSM (22,5 billion). 35 of the 85 billion euro were directly allocated to stabilise the banking sector. The EFSF issued its first bonds on 25 January 2011 with great success (demand was 9 times higher than the quantity offered on the market)[45], Ireland would have received the loans with a time frame of 5 years and six months and interest rate of 5,9%. The Adjustment Programme included a downsizing and reorganisation of the banking sector with recapitalisation & deleveraging, restoring fiscal sustainability though structural reforms both to restore fiscal sustainability and to focus on competitiveness and growth. The Rescue Package was considered a great success, the Troika reviewed positively the measures undertaken by Irish governments and GDP restarted its growth after 2013.[46]

*Figure 3: Irish GDP (World Bank). As it can be observed, the 2008 shock was entirely recovered in 2015 and later the GDP increased by € 200 billion in only 5 years*




[46] Conclusion of EFSF financial assistance programme for Ireland: an overview (esm.europa.eu)

The second country to access EFSF's funds was Portugal in 2011. Portugal's economic situation was quite different compared to Ireland: it was experiencing low GDP & Productivity growth since the early 2000s and low competitiveness caused by structural inefficiencies and high labour costs[47]. The banking sector had difficulties in accessing the international market funding and public debt raised up to 100% of GDP in 2010. As for Greece and Ireland, sovereign spreads started to rise together with yields and on April 2011 the resigning Prime Minister formally requested financial support to EFSF since the country faced a status of bankruptcy. The loan provided to Portugal consisted of €78 billion granted by the Commission equally divided by the EFSF, the EFSM and the IMF, each contributing with € 26 billion. The loans had a 5 years term with an interest rate of 4,6%[48].

The Adjustment Program, agreed and signed in May 2011, included measures to guarantee fiscal consolidation (budget deficit cut from 9.1% to 3.0% in 2013), financial stability and structural reforms to boost the country's long-term growth, starting with the aim of a price reduction to regain competitiveness. While Ireland managed to restart and grow, the austerity programme in Portugal initially had negative effects experiencing recession, unemployment and lower wages[49]. One of the main reasons behind the different success between Ireland and Portugal was related to the nature of the crisis: while Ireland had experienced almost two decades of strong economic growth (which, unlike Greece, was not mainly driven by domestic public spending but included great amount of foreign investments), Portugal had to face stronger structural inefficiencies which cumulated for over a decade and which required ambitious reforms and reorganization of public expenditure to improve the efficiency of social spending. Despite the initial difficulties and public protests against the austerity programmes, Portugal managed to regain credibility on international financial markets with Bond yields as low as 3.4% in 2014 during the exit of the program (Yields were about 9.8% in 2011 and reached a record of 18.3% in 2012) and implemented ambitious and effective reforms which in the medium term had a positive impact on

[47] Data From: OECD World Bank – Portugal – World Bank Data, OECD – Portugal Country Statistical Profile

[48] PORTUGAL (europa.eu) – Memorandum of Understanding (17 May 2011)

[49] World Bank, OECD

competitiveness & economic growth. For the first time in 20 years Portugal turned current account deficit into a surplus in 2013 (ESM)[50] , public debt declined in 2014 and GDP started a consistent growth reaching +3,5% in 2017[51] and continuing its positive growth up until the Covid crisis of 2020.

### *Greece, the 2nd & 3rd bailout*

The Third Country who had to access EFSF's funds was Greece which only 2 years after the first bailout needed a new adjustment programme. As previously mentioned, Greece could not manage to successfully implement the necessary and ambitious measure imposed by the Memorandum of Understanding: GDP growth and Real domestic demand were lower than expected, gross debt was almost 30 percentage points higher than initially forecasted and exports did not increase enough to rebalance the decrease in domestic demand[52]. The reasons behind the disappointing result of the Memorandum of Understanding have been largely analysed and discussed both by the academic community and by European Institutions themselves which commissioned several reports and in-depth analysis to recognise the mistakes made and develop more effective responses in the future. A research carried out by Pisani-Ferry et al. in 2013[53], later included in a Committee Study if the EU parliament (Economic and Monetary Affairs Committee)[54] recognised several factors which contributed to the failure of the first adjustment programme: an external macroeconomic environment which turned

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[50] Conclusion of EFSF financial assistance programme for Portugal: an overview (esm.europa.eu)
[51] Eurostat, Portugal Country Profile (Portugal country profile (europa.eu))

[52] Data: Eurostat, IMF

[53] Pisani-Ferry, J., Sapir, A., & Wolff, G. B. (2013) "EU-IMF assistance to euro-area countries: An early assessment", Bruegel Blueprint Series, Volume XIX

[54] Sapir, Wolff, De Sousa, Terzi (2014) "The Troika and Financial Assistance in the Euro Area: Successes and Failures", study on request of the Economic and Monetary Affairs Committee, http://www.europarl.europa.eu/ECON

out to be worse than expected, EU policy late response, Unsuccessful implementation of the adjustment programme, late debt restructuring, excessive austerity and failure to boost exports.

The Second adjustment programme followed the same structure of the Portuguese and Irish Bailout with the intervention of both the EFSF and the IMF. The second bailout shifted to the EFSF the 34.4 billion remaining of the Greek jurisdiction bonds and the new package included new loans for 130 billion euro, 19.8 of which granted by the IMF [55]. The new programme included new goals such as expenses cuts ant debt to GDP reduction from 176,7 to 120% and required new reforms especially for the pension system and privatizations. The two main differences with the first adjustment programme were related to the presence of the EFSF (no more bilateral loans) and the debt restructuring which cut the nominal value of the bonds in the hand of private investors by 53,5% and lengthened the maturity profile from 11 to 30 years. Despite the different political climate than in 2010 and the more realistic targets of the plan, the political situation deteriorated with political instability and the new government guided by Antonis Samaras started asking to the Troika and Euro Area member states (namely Germany and Northern countries) for more time to implement the measures and reforms requested by the Memorandum of Understanding. The Troika negatively reviewed the progresses made by the Greek Government and the report of fall 2012[56] specifically addressed the excessively slow fiscal consolidation and battle against tax evasion, the non-implementation of government properties sales and privatizations.

When in 2014 the country started a slow recovery, being able to borrow money on the financial markets for the first time after more than 4 years and to show low but sustainable growth, the political situation fell down again and in January 2015 the leftist politician Alexis Tsipras won the elections with his "stop austerity" program. The new government immediately experienced complex relations with the Troika and its creditors which refused to approve the last funds without a list of reforms guaranteeing that Greece would have continued on the same path started in 2012 with the first

[55] European Commission (2012) "The second Adjustment Programme for Greece" Occasional Papers 94 Greece (europa.eu)

[56] European Commission (2012) "The second Adjustment Programme for Greece, first review (December 2012), Occasional Papers 123 (europa.eu)

reforms. Tsipras declared that he would not have respected the previous agreements and when the government for the first time did not repay a 1.6 billion loan instalment to the IMF[57]. The fatal shot was given by the Referendum of July 15 when Greek citizens rejected the agreement with Troika institutions and for two weeks the economic and social situation completely crashed. ATMs stopped giving money and creditors were not anymore willing to lend money unless the government gave proof of trust. In only six months all the progresses made in years of austerity and sacrifices were lost and a third, tougher bailout became necessary with all Euro Area states (including those who were experiencing a bailout programme) joining hostile position against the Greek government. The third bailout involved exclusively the new-born European Stability Mechanism (ESM) which contributed with a loan of 86 billion while the IMF did not take part in the third bailout after the political events of the previous months and the missed payment of 1,6 billion for Spring 2015.

[57] IMF (2017) Greece, Ex-Post Evaluation of Exceptional Access under the 2012 Extended Arrangement (cr1744.pdf)

## 3) The European Stability Mechanism and the Spanish Bailout

### *From the EFSF to the ESM*

*"The EU must get a grip on the issue of economic governance. It is not solely a matter of restoring liquidity and confidence in the banking sector, but of laying the foundations for a new economic model that will give Europe a global competitive edge. It is clear that Europe needs a common and concerted plan of action for growth based on a high degree of consensus if it is to surmount the considerable challenges its economies will face in the years ahead."* [58]

Sony Kapoor defines three fundamental pillars for crisis management[59]: prevention, mitigation and resolution. The political debate between 2010 & 2011 focused on those three pillars and the new ESM had to include all of them in order to gather the necessary consensus for its creation as a stable instrument. The main issue was again the "no bailout clause" on art. 125 TFEU, which was nevertheless representative of the overall debate within the Euro Area on how to implement an effective crisis management without giving incentives for Moral Hazard. The "legal" aspect of the issue was addressed by the European Council of 16-17 December 2010[60] which modified Article 136 TFEU[61] with a new paragraph establishing a permanent stability mechanism for financial assistance to a Eurozone member in case of a risk for the stability for the whole euro area:

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[58] Verhofstadt, G., J. Delors and R. Prodi (2011), "Europe must make a plan for reform, not a pact", Financial Times, 3 March (ft.com)

[59] Kapoor, S. (2010), "Building a Crisis Management Framework", in Euro Area-governance. Ideas for crisis management reform, European Parliament, September

[60] European Council Conclusions 16-17 December 2010

[61] Art 136 TFEU par. 3 (EUR-Lex - 12016E136 - EN - EUR-Lex (europa.eu))

*"The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."*

Now that a legal basis for the creation of the ESM was created, the year 2011 was marked by debates for its establishment and the definition of the treaty signed on 2 February 2012[62] by the governments of the Euro Area and entered into force on 27 September 2012 when Germany ratified the treaty so that member states representing at least 90% of the capital requirements had all ratified the new ESM. The ESM was to replace the EFSF established in 2010 and which was planned to expire in 2013, three years after its establishment.

The political event which ultimately granted the possibility for the creation of the ESM as a stable instrument was the informal agreement between the French President Nicolas Sarkozy and the Chancellor Angela Merkel for a new treaty and not a simple amendment for the EFSF and the EFSM. The new treaty was to be designed in order not to have the need for referendums to avoid the risk of internal disagreements and guarantee a fast ratification process.

### ***The European Stability Mechanism***

The main purpose of the ESM, as stated on Art. 3 of the ESM treaty, is to "*mobilise funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States."*

*The Governance*

The ESM is governed by a Board of Governors composed by finance ministers of the 19 euro area member states (Art. 4 & 5) chaired by either the president of the Eurogroup or by a chairperson elected among its members (Art. 5 par. 2). The member

[62] Treaty Establishing the European Stability Mechanism, 2 February 2012 (esm.europa.eu)

of EU Commission in charge of Economic & Monetary Affairs, the ECB president & the Eurogroup president may participate as observers in the meeting of the Board of Governors (Art. 5 par. 3). The BoG takes all major Decisions by mutual agreement such as capital increases, granting of Financial Assistance, cancel the emergency reserve fund and transfer its content back to the reserve fun or paid in capital, change pricing policy and pricing guideline for financial assistance (…) (Art 5 par. 5).

The Executive body of the ESM is the Board of Directors composed by 19 directors appointed by the governors revocable anytime, the Commissioner for Economic & Monetary Affairs and the ECB president may each appoint one observers to participate to the BoD (Art. 6 par. 1, 2). The BoD is chaired by a Managing Director which with the Management Board composed of 6 additional members conduct the ongoing business of the ESM. The role of the BoD is to ensure the correct implementation of the Treaty Establishing the ESM and take decisions by qualified majority (Art. 6 Par. 5, 6). The ESM also includes a Board of Auditors as an independent oversight body in charge of checking the regularity, compliance performance and risk management of the ESM (Art. 29, 30) and on an annual basis it will draw up a report to be submitted to the Board of Governors (Art. 30 Par. 4). The First ESM managing director was Klaus Regling (already the head of the EFSF) and was appointed for two mandates up to October 2022; the new Managing Director as for 2023 is the Luxembourgish Pierre Gramegna, former minister for Finances of Luxembourg.

*Funding Capacity & Capital.*

The ESM has an authorised capital stock of EUR 708,493.7 million, divided in 7,084,937 shares with a nominal value of EUR 100,000 each. The obligations of ESM members to contribute to the authorised capital stock are not affected if any ESM member becomes eligible or is receiving financial assistance from the ESM itself. Of the authorised Capital, the initial Paid-in capital has a nominal value of EUR 80,970 million (Art. 8, 9). The Maximum lending capacity can reach EUR 500 bn. If a EU Member State becomes adopts the Euro, it must become a member of the ESM (Art. 44).

The ESM bills bonds on the market with maturities from 1 month to 45 years; such bonds can be issued via syndications, auctions, private placements and the ESM can also borrow from ESM members, financial institutions or other third parties. The ESM has a preferred creditor status second to the IMF only (differently from the initial creditor status of the EFSF during the Financial Crisis) (Art. 8, 9, 42)

***Contribution Keys of the ESM (Annex I, ESM Treaty)***

| **ESM Member** | ***ESM Key (%)*** |
|---|---|
| *Kingdom of Belgium* | *3.4250* |
| *Federal Republic of Germany* | *26.7402* |
| *Republic of Estonia* | *0.2527* |
| *Ireland* | *1.5684* |
| *Hellenic Republic* | *2.7745* |
| *Kingdom of Spain* | *11.7256* |
| *French Republic* | *20.0809* |
| *Republic of Croatia* | *0.5215* |
| *Italian Republic* | *17.6457* |
| *Republic of Cyprus* | *0.1933* |
| *Republic of Latvia* | *0.2732* |
| *Republic of Lithuania* | *0.4042* |
| *Grand Duchy of Luxembourg* | *0.2647* |
| *Malta* | *0.0892* |
| *Kingdom of Netherlands* | *5.6315* |
| *Republic of Austria* | *2.7418* |
| *Portuguese Republic* | *2.4716* |
| *Republic of Slovenia* | *0.4643* |
| *Slovak Republic* | *0.9791* |
| *Republic of Finland* | *1.7706* |
| ***Total:*** | ***100%*** |

*Financial Assistance*

Following Art. 12 of the treaty the ESM may provide stability support to an ESM member subject to strict conditionality which may range from macro-economic adjustment programme to continuous respect of pre-established eligibility conditions. The procedure for granting stability support delegates to the European Commission and the ECB to assessing the existence of a risk for financial stability of the Euro Area as a whole; the IMF can be included in the assessment of the sustainability of the public debt. If the Board of Governors decides to grant support to an ESM member it will entrust the European Commission and the European Central Bank in the task of negotiating a Memorandum of Understanding with the conditionalities attached to the financial assistance facility. The Memorandum of Understanding must be consistent with the provisions of economic policy coordination of the TFEU. (Art. 12, 13).

The ESM can act following 5 different financial assistance instruments (from Art. 14 to Art. 19). Precautionary Financial Assistance (Art. 14) offers a credit line to support sound policies and prevent crises and is not conditional to a full economic adjustment programme but a *lighter* Memorandum of Understanding is needed. The Financial Assistance for the re-capitalisation of financial institutions of an ESM Member (Art. 15) has the specific purpose of re-capitalising financial institutions of an ESM Member, it was used to support the banking sector of Spain in 2012.

ESM loans (Art. 16) can be granted to an ESM member with specified terms and conditions in a financial assistance facility agreement after conditionalities are attached in a macro-economic adjustment programme. Primary and Secondary Market Assistance Facilities (Art. 17 & 18) allow the ESM to purchase bonds both on the primary and secondary market to restore a relationship of trust between the investment community and the Member States facing an Adjustment Programme; secondary market purchases can be applied also to countries not under a programme with conditionalities specified in a financial assistance facility agreement.

In December 2014 the BoG adopted a new instrument, the ESM Direct Recapitalisation Instrument for Euro Area Financial Institutions. This instrument,

with a limited amount of resources available of € 60 million, can act as a last resort measure to recapitalise a systemic and viable euro area financial institution directly. This specific instrument is one of the pillars of the EU Banking Union along with the supervision of the Euro Area by the Single Supervisory Mechanism and the creation of creation of the Single Resolution Mechanism. The ESM was included in the Banking Union to increasingly reassure markets and safeguard financial stability in the Euro Area.

So far only two instruments have been used, the stability Support loan (ESM loans) and the Financial Assistance for the re-capitalization of financial institutions.

The ESM establishes a reserve fund and the BoG has the possibility to establish other funds if appropriate; the resources of the reserve fund will be invested following the guidelines provided by the BoD (Art. 24). The BoD can decide to distribute a dividend among ESM member states when the among of paid-in capital and reserve fund exceed the level required for the ESM to maintain its lending capacity (Art. 23). The operations charged in case of losses fall firstly against the reserve find, secondly against the paid-in capital and finally against an appropriate amount of the authorise unpaid-capital.

The form of Involvement of private sector in supporting a member state is determined by the ESM by following IMF-best practice. If debt sustainability analysis does not suggest that an adjustment programme can restore debt to a sustainable path, the beneficiary member state will be required to involve the private sector. The support funds provided by the ESM must cover ESM funding costs plus an additional margin. The original planned pricing structure includes a charge of 200bp for the entire loan and a surcharge of 100bp for loans above 3 years.[63]

[63] Credit Suisse (2011) "EFSF (R)evolution, An analysis of the developing infrastructure of the EFSF and ESM"

***Spain & the Banking Crisis***

If all the European Countries which between 2007 – 2014 faced severe economic downturn were to be considered, the main drivers behind the Spanish Economic Crisis would probably appear the easiest to assess and understand by anyone analysing the European Sovereign Debt Crisis. The central factor causing the crisis was undoubtedly the bubble in the housing sector which started arising in the late 1980s and slowly shaped the entire Spanish Economic System which strongly relied on the constant (and unsustainable) growth of the housing sector[64].

*The Spanish Property Bubble*

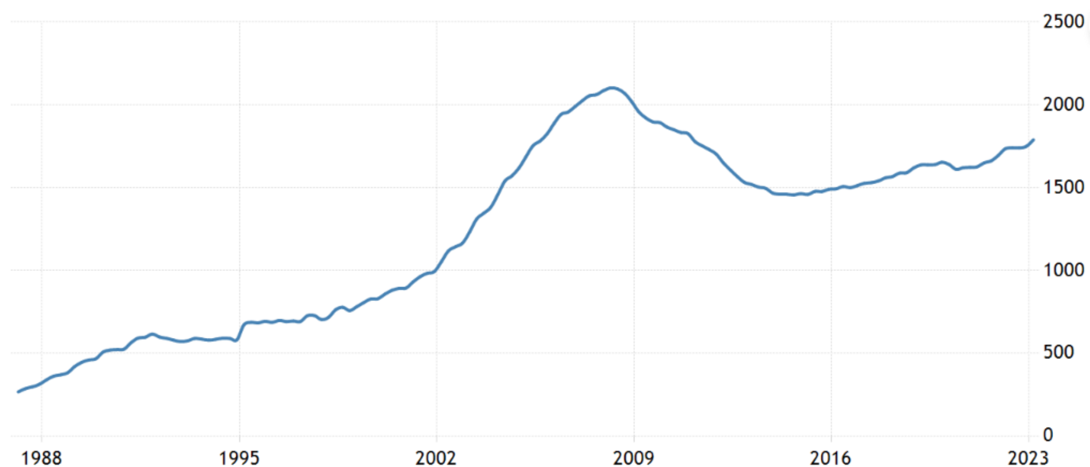


*Figure 4: Average House Prices per Square Meter - Ministerio de Fomiento*

The Spanish housing sector started its growth in 1985, with average nominal prices doubling in only 6 years and reaching almost 3000 euro per square meter in 2007, right before the subprime crisis in the U.S. and the burst of the real estate bubble in the

[64] Jimeno, J.F., Santos, T. (2014) "The crisis of the Spanish economy", *SERIEs* **5**, 125–14 https://doi.org/10.1007/s13209-014-0116-8

New World.[65] The growth of the housing sector and nominal prices in Spain had brought to a great amount of investments in the construction sector and between the years 2000-2008 5 million new housing units were built (a 25% growth in the number of units considering the existing stock was 20 million)

As a consequence of this growth, employment in the construction sector reached 14% of the total[66] and real prices increased by 127% from 1996 to 2007. One of the main factors which contributed to the growth of the sector were the low interest rates guaranteed by the EMU which allowed millions of Spanish citizens to borrow money at very low cost from banks to invest in a sector perceived as safe and whose growth was considered inevitable. Everyone, especially young people, had the chance to access financing from banks to buy a house and the government incentivised loans from bank by offering a 15% deduction of mortgage payments from personal income taxes. The final result of the combination of all those factors was a country whose economic growth and public finance sustainability was almost entirely based on the unsustainable growth of the housing sector.

25% of the population had to repay a mortgage, the average length of mortgages reached 25 years in 2004 and most of the loans were granted by local banks (56% in 2009) which were non subject to strict banking supervision. Private sector Debt reached 276,10% of GDP in 2007[67] with household debt reaching 85% of GDP in 2011. This data was particularly worrying for a country like Spain which had low domestic savings and which did not have a strong exporting economy which in times of crisis could have sustained internal growth (current account deficit reached 9% in 2007, Eurostat). As a consequence, starting from 2007, house prices fell by 30% in 3 years and assets on which loans were based lost great value and public finances started to show the real weakness of Spain's Economy: fiscal surplus of 2.1% in 2006 became a fiscal deficit of 11.3% in 2009 and public debt to gdp more than doubled in 6 years. In 2011 a great number of banks risked default and a new Economic Adjustment Programme became necessary with an approval of a Memorandum of Understanding

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[65] Martin A., Moral-Benito E., Schmitz Tom (2019) "The Financial Transmission of housing bubbles: evidence from Spain", ECB working Paper Series No. 2245

[66] European Commission, Labour market information: Spain (europa.eu)

[67] OECD: Spain, Financial Indicators (data.oecd.org) – Private Sector Debt

for recapitalization of the financial system by the Eurogroup on 9 July 2012 financed by the ESM (initially EFSF until ESM became available).[68]

On 20 July 2012 the Eurogroup officially agreed to cover financial needs for up to € 100 billion, with loans having an average maturity of up to 12.5 years (maximum individual maturity of 15 years) to support the restructuring of the Financial Sector conditional to important interventions both consisting in bank-specific measures and structural reforms.[69].

*The Bailout*

The main objective of the new programme was to increase long-term resilience of the banking sector as a whole to restore its market access. The plan initially included both bank-specific measures and sector-wide measures. Before the recapitalisation, an identification of bank capital needs was necessary through quality review and stress test; only later impaired asset would have been transferred to an asset management company named SAREB, specifically created to manage & sell *troubled* assets of rescued banks. Other measures to strengthen the financial sector included higher capital requirements, improved bank governance rules, upgraded reporting requirements and strengthened financial regulation & supervision in order to avoid risks of a new banking crisis in the future. [70] [71]

The first disbursement was directly granted by the ESM in December 2012 after a request from the Spanish government of an amount of € 39 billion in the form ESM bills and floating rate notes. The second (and last) disbursement was requested in February 2013 for an amount of € 1.8 billion, reaching a total amount of financial assistance of € 41.3 billion. The Intervention of the ESM was thus covered by Art. 15

[68] Eurogroup (2012), "Statement on the follow-up of the 29 June Euro Summit", EG statement 9 July 2012 (europa.eu)

[69] Eurogroup (2012) "Statement on the meeting of 20 July 2012", (europa.eu)

[70] European Stability Mechanism (2022) Spain, Spain | European Stability Mechanism (europa.eu)

[71] European Commission (2010), "Memorandum of Understanding on Financial-Sector Policy Conditionality", (europa.eu)

of the ESM treaty allowing for The Financial Assistance for the re-capitalisation of financial institutions of an ESM Member.[72] [73] [74]

Among the Conditionalities imposed by the Commission, the focal point was a reduction of the Public Deficit which in 2011 reached 11% to 2.8% in 2014 which should have been achieved through a programme of ambitious structural reforms to address inefficiencies of the labour market and of the public sector.

The Housing Crisis in Spain resulted much more severe than in Ireland as the absorption and adjustment of the Housing Sector was much slower and in the years between 2007 and 2012, while Ireland had immediately faced the crisis with strong reforms and thanks to the EFSF intervention which allowed a rapid reprise of the Banking Sector, Spain did not intervene in time leaving the crisis to increase its magnitude. Before the Adjustment Programme Spain failed to reallocate labour and resources towards exporting sectors (in order to mitigate the Current Account Deficit) therefore causing a need for (potentially) a larger bailout of up to € 100 bn and a deeper crisis of the banking sector.

*The Structural Reforms*

A fundamental point of Spain's path towards economic stability was the reform package implemented by Mariano Rajoy's government which included labour market reforms and cuts in public spending which initially caused great unpopularity and protests against the austerity measures imposed. The first crucial structural reform regarded the labour market which showed structural rigidities and distortions caused by the excessive dimension of the construction sector. The deep insider-outsider divide

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[72] European Stability Mechanism (2013) "Conclusion of ESM financial assistance programme for Spain: an overview", (europa.eu)

[73] European Stability Mechanism (2012) "Financial Assistance Facility Agreement between ESM, Kingdom of Spain, The Bank of Spain & Fondo de Reestructuraciòn Ordenada Bancaria", (europa.eu)

[74] European Commission (2012) "The Final Sector Adjustment Programme for Spain", Occasional Papers 118, (europa.eu)

made the Spanish labour market highly dysfunctional strongly increasing labour costs and penalising more fragile workers who did not have a permanent contract.

Rajoy's reform aimed at increasing the flexibility of a labour market to address high unemployment rates which in 2012 reached 24.8% and had its peak in 2013 at 26.1%. [75] The Strategy for Entrepreneurship and Youth Employment had the aim of promoting the integration of young people in the job market (youth unemployment was almost 50%) through 100 measures of which 15 had a short-term perspective to encourage youth employment and improve education and training to respond to real needs of the labour market.

Other measures included incentives for entrepreneurship & self-employment, programmes of guidance, support & motivations and tax incentives for hiring young people with an overall budget of almost € 3.5 billion. Other major reform plans included Public Administration to increase efficiency and reduce potential obstacles to economic activity and the Education System Reform to face high drop-out rates and increase the capacity to assess learning difficulties through the introduction of universal tests for school performance and a centralization of Education Policies to reduce regional disparities. [76]

Finally, another package of measures implemented by the Spanish Government which were strongly criticised and object of public protests were the almost € 65 billion of austerity measures having the target of fiscal consolidation and reduce public spending. The Memorandum of Understanding clearly stated that Spain had to reduce its deficit in order to reach the Stability & Growth Pact targets (from 11.6%[77] in 2012 to 3%) by the end of 2016. Measures undertaken therefore included cuts in public expenditures and tax increases, a pension reform and reduction of expenditures by all ministries.

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[75] World Bank, Spain, data on Unemployment (% of total labour force) (worldbank.org) – OECD, Spain, Labour Market Data (data.oecd.org)

[76] Ministerio de Empleo y Seguridad Social (2013) "Strategy for Entrepreneurship & Youth Employment 2013/2016", (mites.gob.es)

[77] Banco de Espana, General Government Statistics (BdE)

***Spain, 10 years later***

The Spanish bailout together with its adjustment programme is often considered as a virtuous example of successful intervention of EU institutions thanks to the efficient implementation of the Memorandum of Understanding which included both important financial measures and radical reforms which addressed structural problems with an ambitious long-term perspective.

Firstly considering the banking sector, the bailout programme was clearly successful in avoiding the risk of a major banking crisis with a great number of defaults and insolvencies (and a potential spillover effect in the entire EU banking system): the reviews made by the European Commission and the ECB all positively rated the implementation of bank restructuring without any delays or setbacks and the Spanish banking sector only required € 41.33 billion of the 100 made available by the ESM. This was also a great signal of trust of Financial Markets towards EU financial institutions and interventions, especially for the ESM, as 10-year sovereign bond yields went down about 350 bp since the start of the programme and Spain received great financial investments from private actors in the real economy and became an attractive country for foreign investors.[78]

Within only 2 years the restructuring of the banking sector brought to a deleveraging of its assets, loans and deposits; banks successfully restarted a recapitalisation and the housing market recorrected its prices after its peak in 2008. The intervention in the Spanish banking sector also became a starting point for the creation of the Banking Union at European level with the aim of lowering the risks of a similar situation in the future by increasing the financial supervision and avoid the risk of contagion in case of a financial crisis.

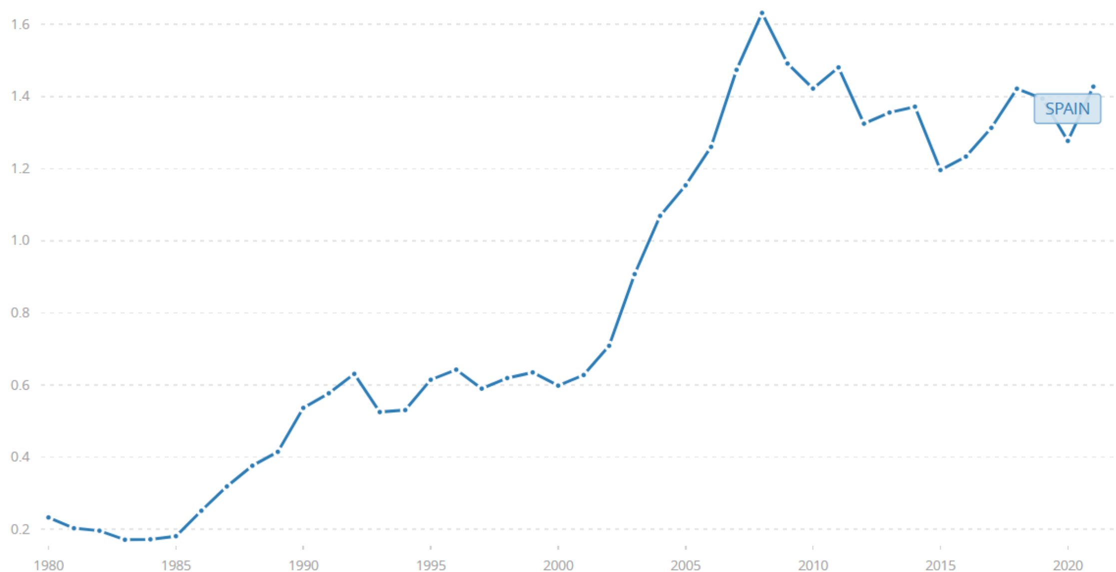
The most controversial point of the Spanish bailout, as for Greece and Portugal, was instead related to the effect of the MoU and the structural reforms on the real economy: the Adjustment Programme initially caused strong internal criticism against both the policies implemented by Rajoy's governments and the Austerity imposed by

[78] European Investment Bank (2019) "2019 Country Overview, Spain", EIB group (eib.org)

the MoU. The years 2012 and 2013 were still marked by Economic Contraction and increased unemployment and many citizens protested against austerity measures. The political scenario was strongly influenced by the initial scepticism towards the reform programme and cuts in public spending with arising Eurosceptic opinions and the success of the party "Podemos", strongly criticising the imposed austerity measures affecting the sovereignty of the Spanish governments and finding in Alexis Tsipras a political ally.

However, austerity measures and an initial economic contraction were arguably a necessary evil and an inevitable consequence in order to re-build an economic system whose growth relied almost exclusively on the construction sector. Spain managed to successfully conclude its programme by 2013 to restore its banking sector and re-started its economic growth in 2014 with an GDP increase higher than the EU 27 average reaching 3.8% in 2015 and showing a better economic reprise after the COVID-19 crisis with a 5.5% growth in 2022 with an average growth of 3.5% of EU 27 and 3.5% of the Euro Area countries. Unemployment dropped by 12 percentage points between 2013 and 2019.

*Figure 5: Spanish GDP, World bank. Unlike Ireland, the Economic Reprise has been much slower and reduced. However, it is important to underline how a great part of pre-2008 growth was related to the unsustainable housing sector.*



Net exports contributed to the improvement of economic growth and in 2013, for the first time since 1986, current account balance registered a surplus of € 27

billion and remained positive also during the Covid-19 crisis (World Bank). On the other hand, Spain still today shows structural issues in its economy which have not been effectively addressed through the adjustment programme and reforms: labour productivity has not grown in recent years and is significantly lower than in some peer economies such as Italy & France. [79] Unemployment, despite the considerable decline after 2012, is still one of the highest in Europe at 13% in 2022, more than twice the European average and youth unemployment reaches 28.34%. [80]

## Conclusions on the Chapter I - The Past

***The extraordinary meaning of the ESM in light of cooperation and solidarity as the first instrument of shared financial responsibility.***

As already mentioned, the Economic Financial Crisis started with the bankruptcy of Lehman Brothers and the consequent sovereign debt crisis for the European Continent has been critical juncture in the European Union's history. It has been analysed and commented from different perspectives and with different approaches and it is likely to be the starting point of a great number of future analysis and studies both from a political and economic perspective. The European Monetary Union as it is today has been largely influenced by the Crisis, the European Central Bank has gained a fundamental role in Economic Policy and developed a great number of instruments available in times of crisis, as shown also during the recent Pandemic. The Eurogroup, despite its "informal" nature, has become a central decision-making player during the crisis, also including heads of state and government in its "Eurosummit" form, and during the initial phases of the Pandemic has allowed for immediate and

[79] International Monetary Fund, Arregui N., Yu Shi (2023) "Labour Productivity Dynamics in Spain: a Firm Level Perspective", Issues Paper No. 2023/012 (IMF.org)

[80] Eurostat, Unemployment by Sex & Age, Monthly Data (Spain) – (Europa.eu)

ambitious policy response by the euro-area by finding agreement on an instrument such as the Pandemic Crisis Support by the ESM, which will be analysed in the next Chapter.

The First Greek Bailout, as briefly described in this chapter, has played an important role in raising awareness on the need to reform and complete the Monetary Union to guarantee stability and effective response in times of crisis. The lack of instruments for crisis-response seriously threatened both the financial stability of the entire Euro Area and the political relations between EU member states which had to find a solution in a short period of time. The fierce debate among member states also had strong negative effects on public opinion which perceived the resistance by Northern European countries against the bailout as a lack of solidarity with great consequences on the popularity of EU institutions and the rise of Eurosceptic populist parties both in Southern and Northern Europe as will be further describe in the next chapter.

The European Stability Mechanism is one of the instruments created during the euro-crisis both to guarantee effective and immediate response in case of risks for the stability of the Euro-system and to maintain stability on financial markets during periods of *stress* as a pillar of the Monetary Union reassuring that, if needed, EU institution have the firepower to avoid worst scenarios. This is an interesting element of the ESM as its usefulness is not only shown when a member states concretely accesses its funds; the existence itself of the ESM is already a powerful signal to financial markets both giving assurances on the economic behaviour of its members thanks to the conditionalities attached to the treaty (and the European Monetary Union as a whole) and by guaranteeing that in case of a great emergency, Euro Area member states can provide through the ESM a firing power of more than € 700 billion. The power of the ESM in reassuring financial markets and in enhancing trust has been clearly visible during the Spanish Bailout: despite the dramatic situation in which the Spanish banking system was, the governments only required less than half of the € 100 billion at disposal. The credibility of the institution, guaranteed also by the presence of the Memorandum of Understanding (the MoU is indeed a primary element in the ESM architecture as it is the guarantee on the behaviour of national governments receiving the funds, crucial to re-establish trust towards the country receiving help), reassured private investors which were then willing to invest again their own money in Spain.

The ESM was therefore successful not only in crisis management in general, but also in reducing the costs of a crisis for European taxpayers; an undoubtedly important factor when a context of solidarity and shared responsibility needs to be created.

Even if today, 15 years after the Economic Crisis started, we often take for granted that in times of Crisis the European Union and the Monetary Union will take immediate and extraordinary measures as happened for Covid-19, it is important to remember that up until 2010 the EU and EMU did not have at disposal or had previously adopted any of the instruments of unconventional monetary policy or other extraordinary measures by the ECB or the European Commission, EU Council and EU Parliament.

This is one of the reasons why the ESM has to be considered a crucial achievement not only for the Monetary Union per-se as a technical instrument, but also for the entire European Union as a demonstration of its capacity to overcome apparently unsurmountable obstacles in a spirit of solidarity to face great historic challenges united and stronger. The ESM is indeed the first EU-level instrument to enhance solidarity for monetary matters which managed to introduce concrete shared responsibility among Euro area member states.

As described, the intervention by the EFSF and ESM with the other institutions of the Euro Area also received many criticisms, especially in the first years when the harshest measures of austerity had to be implemented. On the other hand, the results showed by more recent data have been largely positive, with strongly improved fiscal deficits of bailed-out states and a strong consistent growth for countries such as Spain and Ireland (in 2016 GDP growth of bailed out countries was, on average, 1.4% point higher than the Euro Area as a whole). The banking sectors of Ireland and Spain, after having been largely exposed with the risk of default for several bank institutions, managed to de-leverage the risk and to diversify their exposure by reducing the relevance of the housing sector.

Jean Claude Juncker in the speech in occasion of the 20th anniversary of the Euro in front of the European Parliament[81] has underlined the mistake initially made before the financial crisis in believing that the Europe had sufficient strength and instruments to resist without the need for intervention of the International Monetary Fund whose actions in Greece was strongly criticised and controversial. Juncker also mentions his regrets for the lack of solidarity towards Greece & Portugal during the crisis shown by EU institutions and member states underlining how the policy measures later adopted managed to bring back again bailed out countries among the "old European Democracies"

*"If California enters a moment of difficulty, it won't ask for help to the International Monetary Fund, but to the United States of America. And we should have done the same"*

The ESM can indeed be considered the answer to this statement. The ESM is the guarantee that any euro-area member state in case of difficulty will receive the support of the European Stability Mechanism which means, indirectly, it will receive the support of other 19 member states accepting to potentially increase their national public debt in order to guarantee for ESM loans. The ESM is therefore a milestone in Europe's history, despite being largely underestimated in its importance, as the first and currently only stable instrument of shared solidarity taking up the legacy of a crisis which endangered the existence of the Euro itself, and contributing to transform what before could be considered as a simple Common Currency Area in a real, strong, Monetary Union.

[81] 8 Jean Claude Juncker, « Discours par le Président Juncker en plénière du Parlement européen à l'occasion de la séance solennelle pour célébrer le 20e anniversaire de l'euro », 15th January 2019, speech 19/425

# Chapter II – The Present

## 1) The ESM and the Pandemic Crisis

### *A decade Of Euroscepticism*

The Financial Crisis has certainly been a critical juncture in the European Union's history; an event of this magnitude had strong consequences throughout the following decade, shaping the political debate and determining the success of Eurosceptic and anti-system rhetoric. As previously mentioned, the effects of the financial crisis, especially in Southern European countries that entered the adjustment programmes, strongly affected public opinion, which saw first of in the financial system and the *reckless* risk-taking behaviour of banks as the main culprit of the crisis, and then the intervention of the European institutions as an attempt to save those who had caused the crisis and not the will to help the real victims of the economic crash. The main elements that led to a strong public resentment towards the European institutions can be identified both in the economic factors and austerity measures that many European countries had to adopt, and in elements related to national identity in contrast to the imposition of policies by the European institutions and other countries[82].

As far as the economic factors and the merits of austerity measures are concerned, it is not difficult to understand why they have negatively influenced opinions on the European institutions and the Monetary Union: austerity measures and restrictive budget policies implemented in a period of severe economic crisis in countries traditionally relying on strong public-spending policies caused numerous protests in all countries where they were applied. The Spanish movement "15-M", often mentioned as the indignados movement, starting from 2011 managed to gather a great amount of people in protesting initially against Zapatero's government and for the discontent on

[82] Serricchio, F., Tsakatika, M., & Quaglia, L. (2012). Euroscepticism and the Global Financial Crisis*. In JCMS: Journal of Common Market Studies (Vol. 51, Issue 1, pp. 51–64). Wiley.

the 2008 Financial Crisis, later becoming the anti-austerity movement obtaining popularity in the entire European Continent. The Spanish indignados had a great impact in Spain's political history as the new leftist party "Podemos" with his leader Pablo Iglesias gathered consensus starting in 2014 from the protests and became one of the most relevant parties in Spain obtaining more than 5 million votes in 2016 general elections positioning itself as the third party in the Spanish Congress[83].

Comparable protests with Comparable outcomes also happened in Greece, where the anti-austerity movement started protesting in 2010 in the street of Athens with numerous episodes of violence which appeared both on traditional medias and the new Social Networks which played an important role in gathering people and augmenting the visibility of the protesters. As for Spain, a new political movement managed to capitalise the resentment against traditional institutions, austerity policies and capitalist economy; the political party Syriza and its leader Alexis Tsipras increasingly gained consensus and won the elections in 2015 with major consequences on Greece's economic conditions and the chaos after the Referendum on the Austerity programme. Important protests were held also in Portugal and Ireland before and during the bailout programmes and in Italy too, despite not being directly involved in a bailout programme, anti-austerity and Eurosceptic movements had a major impact on the country's political path. During Monti's Technical Governments, which operated major cut in public spending and important reforms on the pension system and labour market to avoid the risk of being unable to finance Italy's public debt (btp-bund spread reached 575 basis points in 2011), the 5 Star Movement gained Consensus becoming the single most-voted party at the 2013 general elections[84].

On the other hand, economic measures and austerity programmes per-se did not explain alone the rising Euroscepticism and the success of populist parties. Other important variables have determined the success of Eurosceptic positions such as National Identities, Political Ideologies and Confidence in National & European

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[83] Ministerio del Interior (2016) Elecciones Generales 2016, interior.gob.es

[84] Conti, N. and Memoli, V. (2015) 'The emergence of a new party in the Italian party system: rise and fortunes of the Five Star movement ',West European Politics38(3):516–34

Institutions[85] [86]. The public support and trust towards European institutions started to decline during the years of the financial crisis (a general discontent towards traditional institutions was registered also in the US, the "Occupy Wall Street" movement is an example)[87] and the general discontent over the EU approach towards countries in financial difficulties. The discontent of the public towards the EU did not only question the content of austerity programmes but the legitimacy itself of EU institutions in defining those programmes. National identity played a major role in causing large discontent as many people started to feel as national governments had lost autonomy and were completely subjected to the decisions of non-democratically elected institutions such as the EU Commission and the European Central Bank. Eurosceptic parties indeed did not directly criticise the integration process per-se[88]; they rather focused on the apparent non-democratic approach by EU institutions and the consequent exclusion of national democratically elected governments from the decision-making process which had to accept the conditionalities under the *threat* of default.

The inability of EU institutions and European Leaders to adopt an effective and positive communication to underline the solidarity aspect gave a great space for Eurosceptic parties to create a negative narrative around Bruxelles and Frankfurt, and political leaders such as Angela Merkel, Wolfgang Schäuble and Barroso did not manage to gain popularity among European citizens. Bank bailouts are usually unpopular and even though the main driver of the sovereign debt crisis were excessive deficits and public expenses, banks (especially French & German credit institutions)

[85] Erika J. van Elsas, Armen Hakhverdian & Wouter van der Brug (2016) United against a common foe? The nature and origins of Euroscepticism among left-wing and right-wing citizens, West European Politics, 39:6, 1181-1204

[86] Lucia Quaglia (2011) 'The Ebb and Flow' of Euroscepticism in Italy, South European Society and Politics, 16:1, 31-50

[87] Calhoun, Craig (2013) Occupy Wall Street in perspective. British journal of sociology, 64 (1). pp. 26-38.

[88] Loveless and Rohrschneider (2011) "Public perceptions of the EU as a system of governance", Living Rev. Euro. Gov. 6

had a great responsibility in lending money irresponsibly taking advantage from a weak banking supervision from banking regulators[89].

A concrete example of the relevance of National Identity and perceived loss of national sovereignty is the Brexit referendum which was held in a country which was not either involved in an Adjustment Programme or was a member of the Euro-Area[90].

Euroscepticism is a multi-faceted phenomenon[91] and has showed different (even opposite) drivers in each single EU country. For example, bailout programmes have been criticised for their excessive severity and austerity in Southern Europe and, at the same time, in countries such as Finland, bailout programmes were criticised as excessively favourable and as incentives for moral hazard.

The Covid emergency is therefore a fundamental event to consider in order to analyse the attitude towards EU institutions and the different behaviour of EU institutions themselves. The disorderly management of the Sovereign Debt Crisis could not be replicated again and EU communication had to be more effective in underlining the willingness to enhance solidarity and help countries who more than others suffered from the Covid Crisis. The measures and the narrative adopted by the Commission revealed itself to be more effective in creating a context of solidarity with the Next-Gen EU fund becoming a widely known and appreciated instrument of shared responsibility with Northern European countries directly contributing with own resources and with the EU Commission having at disposal its own resources. The SURE emergency instrument (European instrument for temporary Support to mitigate Unemployment Risks in an Emergency) is another example of immediate response to the Crisis with € 100 billion in the form of loans granted on favourable terms from EU to Member States to address sudden increases in public expenditure for the preservation of employment.[92] The ECB too adopted new temporary expansionary

[89] This was indeed one of the main drivers which brought the creation of the Banking Union

[90] Paul Taggart & Aleks Szczerbiak (2018) Putting Brexit into perspective: the effect of the Eurozone and migration crises and Brexit on Euroscepticism in European states, Journal of European Public Policy, 25:8, 1194-1214,

[91] Lubbers, M. and Scheepers, P. (2010)'Divergent trends of Euroscepticism in Countriesand regions of the European Union',European Journal of Political Research49(6):787–81

[92] EU Commission (2020), "The European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE)", SURE (europa.eu)

monetary policies with the Pandemic Emergency Purchase Programme in 2020[93] by purchasing different types of assets on financial markets to mitigate the effect of the Pandemic and guarantee stability. An innovating element of this specific ECB instrument was the absence of proportionality in asset purchasing, meaning that the ECB for the first time did not have to respect a country quota based on the subscribed capital and could instead focus on helping countries in most need.

The European Stability Mechanism was included in *the new wave* of policies to help countries in difficulty, with a specific instrument to address the pandemic emergency for countries facing serious difficulties in addressing the pandemic in its sanitary aspects. Similarly to the SURE, the principle was to grant loans at favourable conditions for member states thanks to the AAA status of the ESM which would have assured low interest rates compared to borrowing money directly on financial markets. The ESM Pandemic Crisis Support is an interesting element to analyse also as an example of how the ESM can evolve and adapt to the needs and necessities of its members during time of crisis

### ***The ESM Pandemic Crisis Support***

The European Council of 23 April 2020[94] has been a crucial event of the Pandemic Crisis as European leaders discussed progress on the response to the COVID-19 pandemic both to address the sanitary emergency and to design a roadmap for recovery of the European Economic System. EU leaders endorsed the agreement by the Eurogroup of 9 April 2020[95] for the creation of three safety nets as the first major actions to address the Crisis on a short-term perspective for workers, businesses and Member states with a total amount of resources mobilised of up to € 540 billion. The

[93] European Central Bank (2020) Pandemic Emergency Purchase Programme (PEPP), ecb.europa.eu

[94] European Council conclusions, 23/07/2020, consilium.europa.eu

[95] Remarks by Mário Centeno following the Eurogroup videoconference of 9 April 2020, consilium.europa.eu

European Investment Bank was to create a European Guarantee Fund[96] acting as a protection shield for European Businesses impacted by the COVID-19 Crisis and related measures to limit the spread of the Virus; the fund was set up on May 2020 with € 24.4 billion from 22 EU member states with the aim to generate up to € 200 billion for the economy.

The EU Commission's Support to mitigate Unemployment Risks in an Emergency (SURE)[97] was designed as the safety net for workers by helping member states to finance short-term measures to protect citizens and their jobs by guaranteeing access to loans with favourable terms to avoid paying excessive interest rates due to sudden increases in public expenditure. The Sure Instrument was an important first-of a kind measure introduced by the Commission which for the first time was going to issue social bonds on the financial market with AAA credit rating for up to € 100 billion and was later used by 19 EU member states who requested to access the fund which expired on 31 December 2022.

Finally, instrument designed as a safety net for Member States was the European Stability Mechanism's Pandemic Crisis Support Line to support domestic financing of direct and indirect healthcare, cure and prevention-related costs due to the COVID-19 crisis. After the endorsement of the European Council of 23 April in its conclusions, the Eurogroup on 8 May 2020 defined the specificities of the new facility and its features[98]. The facility, expired on 31 January 2022, was available to all Euro area Member States for amounts of up to 2% of the respective GDP as of end-2019. As provided by Article 14 of the ESM treaty, through the Enhanced Conditions Credit Line (ECCL)[99] the Board of Governors may decide to grant precautionary financial assistance with conditionalities detailed in a Memorandum of Understanding signed with the European Commission (as provided by Art. 13.3) to countries whose general economic and financial situation is substantively sound but present some specific

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[96] European Investment Bank (2020), The European Guarantee Fund, eib.org

[97] EU Commission (2020), EU SURE Social Bond Framework, commission.europa.eu

[98] Eurogroup Statement on the Pandemic Crisis Support (2020), Consilium.europa.eu

[99] ESM Treaty (2012), Art. 14

weaknesses.[100] The Pandemic Crisis Support Facility was created under the ECCL and not under the PCCL (Precautionary Conditioned Credit Line) also included in Art. 14 of the ESM treaty as the PCCL would have required for the member state accessing the funds to fulfil specific criteria enlisted in the ESM guideline list for the precautionary financial assistance: [101]

- Respect of the commitments under the Stability and Growth Pact;
- A sustainable general government debt
- Respect of the commitments under the excessive macroeconomic imbalance procedure;
- A track record of access to international capital markets on reasonable terms;
- A sustainable external position; and the absence of bank solvency problems that would pose systemic threats to the stability of the euro area banking system.

Considering the emergency situation of the Covid-19 Crisis, those conditionalities may have prevented the intervention of the ESM new facility in those countries in which if could have been needed the most especially considering that the commitments under the Stability & Growth Pact were not fully respect by a number of countries.

The only prior conditionality therefore defined by the Eurogroup to access the facility, as previously mentioned, was the commitment of a member state to apply resources to direct and indirect healthcare, cure and prevention costs due to the Covid-19 crisis. This commitment, once the Member State had asked for help, would have been included in the Memorandum of Understanding.

The Pandemic Crisis Support Facility was adopted by the Board of Governors on 15th May 2020. Financing to the requesting Member State would have been provided through disbursement under a loan or a Primary Market Purchase. The Loans had a maximum average maturity of 10 years and at an annual interest rate of 10 points basis (0.1 per cent), plus a 25 points basis (0.25 per cent) service fee for each disbursement. The ESM would have financed itself on financial markets to provide the requested

[100] Mauro Megliani, 'The ESM Pandemic Crisis Support Facility: A Changing Conditionality?', (2022), 33, European Business Law Review, Issue 2, pp. 227-242

[101] European Stability Mechanism Guideline on Precautionary Financial Assistance, esm.europa.eu

financial assistance and create a "common funding silo" for possible drawdown requests. Social Bonds could have therefore been included to that end.[102]

The Pandemic Crisis Support had therefore better pricing conditions compared to the "traditional" Precautionary Credit Line which charged instead an Upfront Service Fee when applying for the loan of 50 bps[103]. The total additional rate paid by a Member State[104] benefitting from the PCS was around 35.5 bps compared to the 85.5 bps under the standard precautionary instruments.

| | Precautionary Credit Line | Pandemic Crisis Support | Comment/Explanation |
|---|---|---|---|
| Upfront Service Fee | 50 bps | 25 bps | A first Upfront Service Fee on 15% Member States allocated amount will be invoiced at the inception. This fee will be deducted from subsequent fees, when actual money is drawn. |
| Annual Service Fee | 0.5 bps | 0.5 bps | |
| Margin | 35 bps | 10 bps | |
| Commitment Fee | TBD | TBD | Depending on ESM's financial losses |
| Penalty fee | 200 bps over Euribor (or interest payable) | Not specified | |
| Primary market purchases | Additional margin of 35 bps | Not specified* | |

*Figure 6 -Pricing Conditions, A Comparison between Standard precautionary Credit line &PCS. Dias & Zoppé (2020), ESM pricing policy (2014, 2020)*

The Member State receiving the help was supposed to use the fundings only in the healthcare sector with the EU Commission in charge of surveillance. The sector-specific nature of the facility could have raised doubts on its compatibility and coherence with the ESM's general aim to help a country facing a severe financial problem. However, as for the banks bailout for Spain, the main argument justifying

[102] Dias, C. & Zoppé, A., 2020. The ESM Pandemic Crisis Support, EPRS: European Parliamentary Research Service. Belgium.

[103] Pandemic Crisis Support Guidelines (esm.europa.eu)

[104] In addition to the price paid by the ESM on its borrowing

the intervention was related to the potential general de-stabilising effect of a breakdown of the healthcare sector on the entire economic system of a single country which later may have had negative effects on the stability of the entire Euro-area. [105]

The early negotiations for the definition of the new instruments to address the Covid-19 Crisis saw initially a great division between Northern and Southern European countries during the virtual conferences of the Eurogroup and the European Council. The Dutch government, backed by Austria and Finland, refused an ESM credit line without conditionalities as requested by Italy and requested for the credit line to include only expenses of the healthcare sector necessary to address healthcare costs of the crisis and to be conditional to a commitment to sound public finances in the medium term[106]. The Northern countries also insisted on the temporary nature of the SURE instrument.[107]

The ESM's limited resources set for only 2% of the GDP of Euro Area countries (summing to a maximum total of €240 billion) did not lower in a relevant way the cost of raising debts of financial markets considering that the European Central Bank's emergency measures and extraordinary purchases kept spreads and interest rates at very low level. It could be argued that one of the fundamental reasons behind the creation of a Pandemic Crisis Support was not necessarily for a country to directly ask for access but to benefit from the stability and trust which the responsiveness of EU institutions would have spread on financial markets. Again what may be defined as a *"whatever it takes"* effect. On the other hand, Euro-area member states usually borrow money at different costs considering their rating and spreads on bonds, therefore while accessing the ESM fundings for Northern countries with sound public finances may have resulted almost irrelevant, the same thing could not be affirmed for countries with higher debt-costs. On of the countries in which the debate has been most fierce and which could have arguably benefitted from borrowing money through the Pandemic Crisis Support rather than directly on Financial Markets is Italy. Recent data

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[105] Corsetti G., Erce A, (2020) Maturity, seniority and size: Make sure the ESM's pandemic crisis support is fit for purpose!, cepr.org

[106] Dias, Zoppè (2020)

[107]Tesche, T. (2022) Pandemic Politics: The European Union in Times of the Coronavirus Emergency. JCMS: Journal of Common Market Studies, 60: 480– 496.

shows how the Mediterranean country could have saved almost € 6 billion in interest rates[108] expenses if it had accessed the PCS, which for Italy was available for an amount of € 35 billion. An analysis of Italy's public discourse and reasons for not accessing the ESM PCS is contained in the next Chapter.

## 2) Italy and the Pandemic Crisis Support

The country which Firstly experienced the spread of the Corona Virus in Europe and whose healthcare system was mostly exposed to the crisis was undoubtedly Italy. The Southern European country suffered the greatest number of Covid-related deaths and cases[109] with direct consequences on its healthcare system already in crisis due to its inefficiencies, lack of resources and an aging population with contextual rising expenditures. During the pandemic, Italy was among the countries who experienced the hardest economic downturn in Europe[110] due to the frequent and strict lockdowns and consequent slowdown of economic activity. Therefore considering both the severity of the sanitary crisis and the consequent economic downturn, Italy was likely to be one of the countries requesting the funds of the PCS to tackle in the short term the Pandemic Crisis and to start re-building its healthcare sector with a long term perspective. Furthermore, Italy has a high cost of its public debt which is one of the highest in Europe and even if in the initial period of the Pandemic interest rates were at historically low levels, the Pandemic Support would have guaranteed even lower interest rates and it would also have protected Italy from an increase in interest rates which no more than 2 years later happened due to the advent of inflation at global level.

Despite these premises and the succession of three different governments made up by three different party coalitions, Italy did not present a request to the ESM to access the PCS. Instead a fierce debate about EU financial institutions and the ESM as a

[108] Kalin Anev Janse, Siegfried Ruhl (2020), Why the Covid-19 credit line still makes sense, esm.europa.eu

[109] Data from European Centre for Disease Prevention & Control (ecdc.europa.eu)

[110] Only Spain has experienced a higher decrease in Real Gdp (9% vs 11.3%) - Eurostat

whole started with negative consequences both on public expenditures on interest rates and on the reputation of the ESM as a whole, endangering the ratification of the treaty reform itself. By analysing the main arguments and criticisms put forward by the *critics*, we can define three main areas of concern in which those criticisms can be included: the first area of concern was related to the conditionalities attached. The second area of criticisms questioned the actual savings in interest rates expenditures and the third area hypothesized a negative outcome in terms of credibility and reputation of Italy in case it accessed ESM's funds.

In the next three paragraphs these arguments will be analysed and evaluated in order to understand whether or not behind the Italian refusal of accessing the Pandemic Crisis Support there were concrete and realistic concerns or instead this decision was driven by ideological positions and *political strategy*.

### ***The Conditionalities***

One of the Main criticism against the European Stability Mechanism could be shortly described as a figure of speech. The ESM is often a Synecdoche, a part which is put for the whole; the "whole" being the European Union and its financial institutions and their economic perspective made of strictness & conditionalities. In Italy, The ESM is therefore often considered (and described by many politicians) as a concrete instrument to impose austerity and strict financial policies from Northern European countries to Southern EU countries through conditionalities and restrictions to access the funds of the ESM. This specific perspective is often put forward by Eurosceptic politicians who criticize the apparent lack of solidarity which characterizes the ESM, which imposes conditionalities and a Memorandum of Understanding for countries accessing the funds which do not have sound public finances as both is required by the PCCL and the Primary and Secondary Market Assistance Facilities.

This argument has its strong origin in the European Sovereign Debt Crisis, especially in the first months if the Greek crisis when the lack of a spirit of solidarity has caused strong unpopularity of EU institutions and hostile relationships between Northern and

Southern European countries[111]. While, as also described in the first chapter of this thesis, numerous mistakes have been done in the first months of the financial crisis and a lack of solidarity clearly had negative consequences both on the economy and the public attitude towards EU institutions, the ESM should be considered as the answer to the need for solidarity. It was created as the first instrument of shared responsibility for monetary crisis and, as of today, there are no other stable European facilities with similar characteristics and the same potential amount of resources at disposal.

The SURE instrument (SSS) is often used as an example by those who have criticized the ESM Pandemic Crisis Instrument of how the EU's approach to crisis management should instead be structured. Unlike the PCL, the SURE instrument was strongly supported by Italian politicians as it did not present any conditionalities both prior to the access to the funds and on how the fund themselves had to be spent. Mangia & Saraceno[112] in an article from December 2020 proposed a "Pandemic SURE" arguing that the ESM Pandemic Support was an unsuccessful adaptation of a financial instrument built to guarantee financial stability rather than enhancing solidarity among member states and therefore unfit for its purpose. The fact that SURE was used by all EU countries while no one has accessed the PCS was a demonstration of the unfitness of the ESM for this purpose. Following this position, the Pandemic Support was an instrument which hid conditionalities as formally it only required for the resources to be spent[113], but concretely it introduced strong supervision & surveillance by both the BoD & the European Commission due to the inextricable bond between the Two Pack[114] macroeconomic Surveillance and the access to the ESM funds. This perspective was adopted by many political parties, from the *Movimento 5 Stelle* to the *Lega* and *Fratelli d'Italia* which described the ESM and the PCL as a "Trojan Horse" of

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[111] An example of How this environment has continued after the crisis is related to the first negotiations of the Next Gen EU funds and the strong reaction resulted from declarations of Dutch PM Mark Rutte

[112] Mangia & Saraceno (2020), MES Sanitario o Sure Pandemico? Open.luiss.it

[113] Matteo Bursi (2021), La Linea sanitaria del MES: né leviatano, né panacea, link

[114] Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area – COM 2011/0819 Final

the EU Commission to impose again strict conditionalities and austerity over Italy (and other countries who may have accessed the instrument).

This perspective is however disproved both by the history itself of the ESM which was created in a spirit of solidarity to avoid the need for the intervention of the IMF and of a new "troika" to never repeat the Greek experience and by the specificities of the new Pandemic Crisis Support itself. The PCS is indeed a result of an even stronger effort to expand the solidarity dimension behind the ESM as the Pandemic Support presents a social assistance characterisation even if Pandemic Crisis Support facility is an upstream backstop to protect economy against the spill-over effects of the pandemic and not a stimulus for the economic recovery[115]. Justifying the lack of conditionalities of the PCS was not indeed an easy job as it had to be compatible with the ESM treaty and the TFEU itself to satisfy the no-bailout rule in a period in which the suspension of the budgetary requirements under the Stability & Growth Pact were suspended. The complexity of guaranteeing a strong legal background for the Pandemic Support under the ESM was caused by the lack of conditionalities of the new instrument, confirming the great effort of the Commission and the BoG in prioritizing solidarity in the struggle to guarantee financial stability in a period of deep crisis such as the Covid-19 pandemic.

### ***The Savings***

Another Criticism posed against using the PCL was related to the actual advantages in terms of interest rates savings of borrowing money from the ESM rather than issuing new debt on financial markets. Many argued that accessing the PCL was unnecessary considering the long period of low interest rates experience on financial markets and the consequent low-cost of public debt. The ESM itself concluded in Summer 2020 that for the ESM lending rates (10 years yield) for the Pandemic Crisis Support were

[115] Mauro Megliani (2020), The ESM Pandemic Crisis Support Facility: A Changing Conditionality?, link

below zero (-0,12%) thus ten Euro Area members[116] states would have benefitted from lower interest rates if they had accessed the Pandemic Support with Greece, Italy and Cyprus being the states who would have saved the greatest amount of taxpayers' money.

Considering the interest rates paid by Italy on its public debt, the ESM had already calculated the great benefit in terms of total savings also after the extraordinary measures undertaken by the European Central Bank which lowered yields in March 2020. As shown on figure 8, Italy could have saved at least € 3 billion in interest rates in a *worst case scenario,* with peaks up to € 7-8 billion thanks to the AAA credit rating of the ESM.

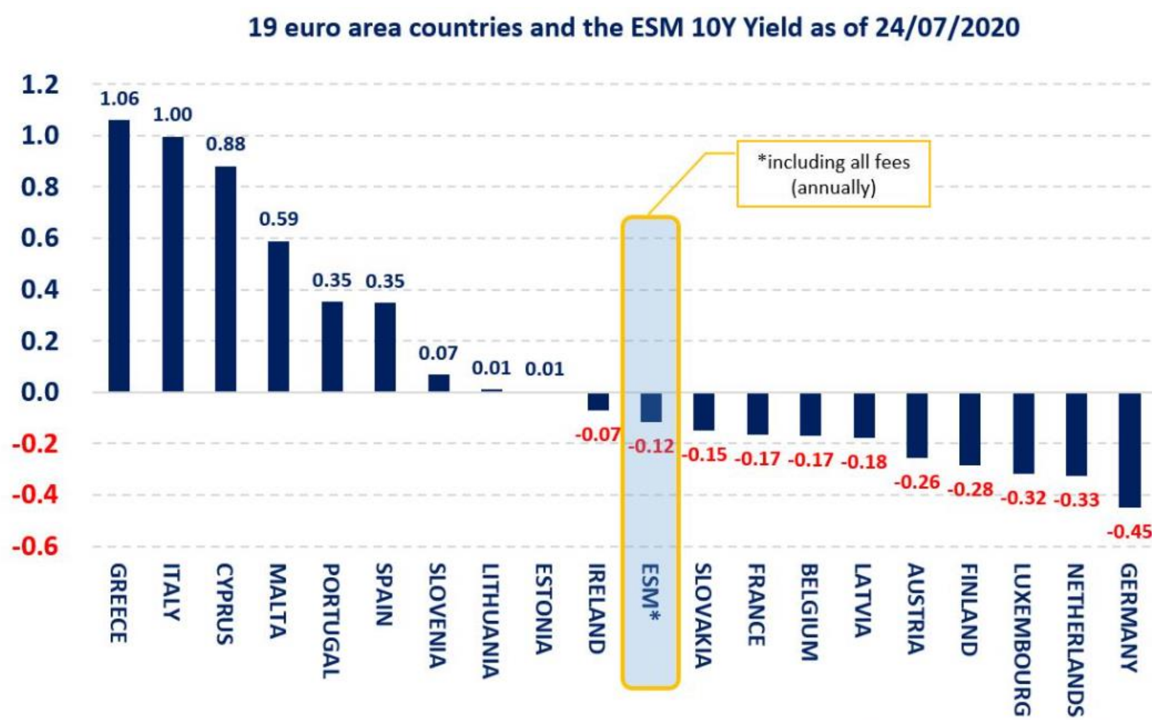


*Figure 7 – Euro Area Countries and the ESM 10 year Yield – ESM.europa.eu*

[116] namely Estonia, Ireland, Greece, Spain, Italy, Cyprus, Lithuania, Malta, Portugal and Slovenia

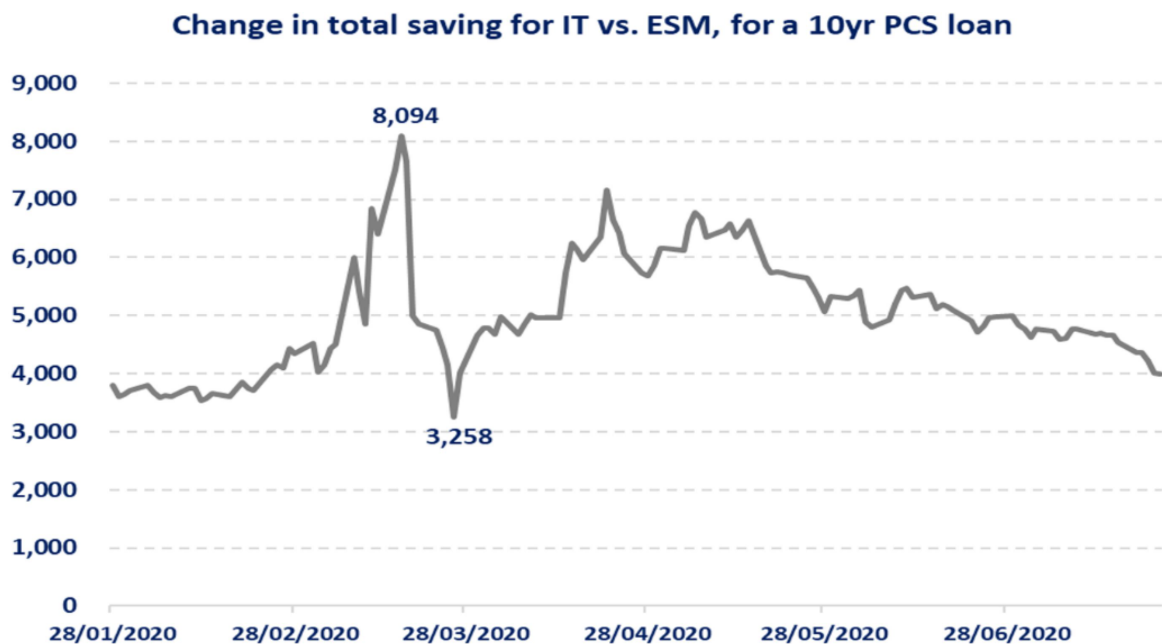


*Figure 8: Total Savings for the Pandemic Crisis Support. ESM aggregation from ESM & Bloomberg Data*

The criticisms against the supposedly low cost-savings of the PCS became even less plausible between the end of 2020 and the start of 2021 when the economic debate started to focus on the potential increase of inflation which then started rising in March-April 2021 reaching the highest rates in 30 years during 2022. This would have inevitably had effects on the cost of public debt, especially for countries with low credit rating such as Italy, which indeed have seen its 10 years bond yields raising 5 times higher between 2021 and 2022, when the PCS would have still been available for access. Accessing the PCS would have therefore been a positive choice in lights of saving taxpayers' money both on a short & long term perspective considering the favourable conditions granted by the PCL and the rising inflation already experienced when the PCS was still available.

### ***The Reputation***

Finally, one last criticism focused against the bad reputation which would have resulted for a country accessing the PCS. Being the ESM a lender of last resort, asking for its support would have been a bad signal to financial markets which would have perceived the activation of the PCS as a proof of financial instability and poor economic conditions. Also in this case, despite the apparent logic and reason behind this argument which was largely used by politicians, the Eurosceptic tendencies of Italian politics and the frequently imprudent approach to budgetary policies created a scenario in which accessing the ESM PCS would have most likely caused an opposite effect.

For a country always reluctant in accepting conditionalities and external support from European Institutions, requesting the funds of the PCS could have been a signal of political maturity and awareness on the importance of lowering interest rates expenditures as much as possible and on spending carefully public resources in crucial sectors both for the current emergency and future developments such as healthcare.

The PCS could have meant for Italy a new era of relations with European Financial institutions, bringing an end to a period of more than ten years of clashes between Italian governments and the EU and of *negative* public opinion which have always concerned investors and financial markets.

### 3) The Reform of the ESM

*"Ladies and gentlemen, I think we have achieved a lot in the last few years. The euro area today is more robust than it was 10 years ago. But there are still some important steps to be taken, in order to make the currency area more crisis-proof and to further strengthen our common currency."*[117]

During the Euro Summit of 14 December 2018 the Head of States and Government of all the Euro Area Countries have endorsed[118] the term sheet on the European Stability Mechanism[119] agreed by the Commission and the ESM which contained a general direction on the further developments of the ESM. These further developments would have regarded a general strengthening of the resilience and crisis resolution capacities through the ESM, a backstop for the Single Resolution Fund (SRF) and a stronger collaboration between the ESM and Commission in assessing macroeconomic and financial risks and debt sustainability of Euro Area member states[120]. The project of reform, rather than a package to correct potential inefficiencies of the ESM and improve its structure by maintaining the original idea, is an ambitious plan to enlarge the institution and its competences and to further include it as a fundamental pillar of the Monetary Union[121]. The ambitious reform project can be considered a confirmation of the ESM's success in achieving the goals for which it was created, disbursing € 295 billion to Ireland, Portugal, Spain Greece and Cyprus. All those countries, before the pandemic crisis when the debate on the reform started, were all out successfully of their adjustment programmes and experiencing high

[117] Klaus Regling (2019), "What comes after the Euro Summit? The role of the ESM in a deepened Monetary Union", Speech by Klaus Regling at the Representation of the State of North Rhine-Westfalia to the EU, 29 January 2019

[118] Statement of the Euro Summit of 14 December 2018, consilium.europa.eu

[119] Term Sheet on the European Stability Mechanism Reform, consilium.europa.eu

[120] 0 G. Claeys, A. M. Collin (2018), Does the Eurogroup's reform of the ESM toolkit represent real progress?, Bruegel [Online] Avaialble at: http://bruegel.org/2018/12/does-the-eurogroups-reform-of-the-esm-toolkit-represent-real-progress

[121] J. Brunsden, M. Khan (2018), Eurozone reform deal: what was agreed and what was put on hold, Financial Times (ft.com)

economic growth and declining unemployment. The ESM could therefore count on a strong background to justify an ambitious reform and an enlargement of its competences, especially in the area of banking supervision after the creation of the Banking Union in 2012 which still did not have a fundamental third pillar completing its structure of the Single Supervisory Mechanism and the Single Resolution Mechanism.

On December 2017 the European Commission Made a proposal to create a European Monetary Fund and to finally include the ESM in the European Union legal Framework[122]. This proposal, if accepted, would have been also an important signal to those countries which saw in the ESM, due to its intergovernmental nature, as an instrument of Northern European countries to impose fiscal austerity on countries with weak public finances, thus affecting their sovereignty. The ESM would have included the competences which later have characterised the reform, such as the common backstop to the Single Resolution Fund, but it would have also become a purely European facility and would have departed from the principle of unanimity which still characterizes the ESM (Even if there is the possibility of votes with qualified majority in the BoG of the ESM, the majority is set at 85%, thus giving the veto power to France, Italy and Germany which alone each represent more than 15% of the shares). The proposal of the Commission also included the possibility of a commissioner being elected at the top of the Eurogroup thus confirming the centrality of the Commission in the new European Monetary Fund and therefore in the Monetary Union as a whole. The proposal initially saw the support of Angela Merkel (Germany had already proposed the creation of a European Monetary Fund during the first months of the Greek Crisis) and Emmanuel Macron.

[122] European Parliament Legislative Train Schedule (2019), Integration of the ESM into EU law by way of creating a European Monetary Fund, europarl.europa.eu

*"As a first step, we need to change the intergovernmental Treaty of the ESM in order to include a common backstop instrument, enhance the effectiveness of precautionary instruments for Member States and enhance its role in assessing and monitoring future programs. And in a second step, we can then ensure the incorporation of the ESM into EU law, preserving the key features of its governance."*[123]

The German and French leaders proposed a compromise in occasion of the Meseberg Declaration, to create the EMF with its innovations and later include it in the European Union legal Framework without changing the governance, maintaining the decision-making power in the hand of member states. Despite the proposal of Germany and France, a group of Northern European Countries, the "Hanseatic League"[124], opposed themselves to the proposal asking for the ESM to remain as an intergovernmental facility without any changes in its governance, agreeing to the backstop and improved instruments to guarantee financial stability by maintaining strict conditionalities and monitoring over countries accessing ESM's funds. The reform of the ESM substantially reflects the position of the "Hanseatic League" by maintaining the intergovernmental structure of the ESM and the strong conditionalities attached to the access of its funds.

The Agreement amending the ESM treaty was signed by ESM member countries on 8 February 2021, providing a new legal framework for a set of new tasks and competences for the ESM. The reform was supposed to come into force in a short amount of time as all the countries of the Eurogroup had signed the agreement and a delay for the ratification of the treaty reform was therefore unlikely. The entry into force was however blocked by the Italian Parliament which did not vote the ratification for more than two years and still, as of 2023, the new right-wing government has not explicitly expressed its position over a ratification of the treaty, by postponing the issue and by showing only moderate scepticism on the nature of the reform.

[123] Meseberg Declaration – Renewing Europe's promises of security and prosperity (signed by Angela Merkel & Emmanuel Macron on 19 June 2018), elysee.fr

[124] Composed by 8 Northern European Euro Area member states, namely Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, Netherlands, Sweden

The Eurosummit of 14 December 2018 approved the guidelines for the ESM reform in light of a broader package of measure to strengthen the Economic and Monetary Union. One of the most important newly introduced tasks of the ESM is indeed providing a backstop to the Single Resolution Fund; in addition to that, the ESM will include an easier application process for the precautionary credit line and will play a more pivotal role in EU's crisis management & adjustment programmes.

### *The Common Backstop to the Single Resolution Fund*

The Banking Union was one of the most important steps taken by EU institutions during the Financial Crisis to increase the instruments at disposal for avoiding future instability and to eliminate risks and causes which brought to the sovereign debt crisis of the early 2010s. One of the areas which needed most an intervention due to the lack of effective supervision and unified regulation was indeed the banking sector: firstly the Greek crisis strongly endangered the solvency of many European banks, especially in France and Germany as banks were excessively exposed on Greek bonds. Later, the Spanish and Irish crisis were directly involving the banking sector due to the housing bubble. Spain, as an instance, had a strongly fragmented banking sector with a great number of small local banks, "*cajas*", which were not under strong supervision and which overly exposed themselves with loans with a great risk of insolvency. The Banking Union was initially designed with three pillars of which only two were actually implemented (Single Supervisory & Single Resolution Mechanism)[125]. The third pillar, imagined as a European Deposit Insurance[126], was not included in the initial project as finding an agreement for raising the necessary resources risked delaying excessively the entry into force of the Banking Union.

The Common Backstop the Single Resolution Fund can be considered a reinforcement of the second pillar of the Banking Union[127], providing a backstop acting as a last resort

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[125] Europea Council, The European Banking Union, consilium.europa.eu
[126] European Commission, The European Deposit Insurance Scheme (finance.ec.europa.eu)

[127] Jasper Aerts, Pedro Bizarro (2020), The Reform of the European Stability Mechanism, esm.europa.eu

instrument subject to principle of fiscal neutrality in the medium-term. The introduction of a backstop on behalf of Euro area member states is an important step to ensure the credibility of the Single Resolution Fund and Financial stability. Since the Banking Union also includes non-euro area member states, non-ESM members participating to the Banking Union are supposed to participate in the backstop by providing a parallel support.

The Common Backstop consists of a revolving credit line and it is quite a different instrument compared to ESM's other facilities. The possibility of providing the backstop facility is guaranteed by modification of Art. 3 including: "*The ESM may provide the backstop facility to the SRB for the SRF to support the application of the resolution tools and exercise of resolution powers of the SRB as enshrined in European Union law"*.

Art. 18a and Annex IV provides specific information on the instrument and how it will guarantee the necessary funds to the SRF. The Common Backstop is activated when the Single Resolution Fund does not have any resources left and will present a request for a backstop facility which will then be taken into account by the Board of Governors which will determine the key financial terms and conditions of the backstop facility, nominal cap and adjustments to it. All the financial terms are going to be specified in a backstop facility agreement with the Single Resolution Board (a sort of Memorandum of Understanding specific for SRF). The Maximum amount for the credit line agreed by the Eurogroup amounts to € 68 billion.

An important change included in the reform is the elimination of the Direct Recapitalization of Financial Institutions once the Common Backstop is effectively established to guarantee that the ESM's overall lending capacity will be maintained. As Aerts and Bizarro explain[128], this is an important step forward as it reduces the risks for the ESM itself: while under the DRI there was a direct exposure of the individual banks receiving the recapitalization, under the Common Backstop the ESM will lend money directly to the Single Resolution Fund. This means that the entire Banking Sector is exposed to the backstop facility, increasing the quality of the ESM's credit, lowering the risks and without affecting the € 500 billion maximum lending capacity. The rating agency Fitch confirmed this aspect in 2018 by declaring that, even if the

[128] Jasper Aerts, Pedro Bizarro (2020)

ESM reform would not have influenced the rating of the ESM already at the maximum level of AAA/Stable, the backstop facility to the Eurozone's Single Resolution Fund will furtherly increase ESM's equity risk profile by replacing the DRI instrument.[129]

The Common Backstop is therefore an important step forwards both in guaranteeing stability for the European Banking System and for the role of the ESM within the Economic and Monetary area. It is an important reinforcement of the second Pillar of the Banking Union and, at the same time, it also improves the structure of the ESM by further improving its risk profile thanks to the substitution of the DRI, with positive impacts on the other instruments and credit lines at disposal of the ESM. Even if the banking Union is still lacking a third Pillar with a Deposit Insurance Scheme, a strengthened Single Resolution Fund lowers the risks of a Banking Crisis or Failure and is an important reassuring signal to Financial Markets, with a positive indirect effect on European savers' bank accounts.

***Precautionary Instruments***

The ESM reform aims at facilitating the access to precautionary instruments which have not been used by member states during the ESM existence due to the strong conditionalities and complex procedures. The ESM has two precautionary instruments, the Enhanced and the Precautionary Credit Lines. As shown by the Pandemic Crisis Support, the stronger conditionalities attached to the PCCL made this instrument less attractive for potential users and also less flexible to adapt it or situation of emergency or crisis, which is why the Pandemic Crisis Support was created under the ECCL. The ESM reform focuses indeed on the PCCL and introduces new parameters for the access by designing a set of pre-agreed eligibility criteria defined in Art. 14.2 and on Annex III. The ESM member asking to access the fund will have to send a signed request highlighting its main policy intentions on a "letter of intent" which will later be analysed by the European Commission entrusted by the BoG to evaluate the compatibility of the letter with the TFEU and EU's economic policy

[129] Fitch's press release (2018) 'Proposed Reform Could Boost ESM's Intrinsic Risk Profile', fitchratings.com

coordination. The most important innovation regarding the PCCL is that a Memorandum of Understanding will not be required anymore, strongly reducing the administrative burden for countries requesting the support. Despite this change, the access to the PCCL still remains complex due to the strong requirements required to ask for the access. The criteria on Annex III include the rules of the Stability & Growth Pact (3% of GDP maximum general government deficit & government debt below 60%), the absence of excessive imbalances, sustainable external position and absence of sever vulnerabilities putting at risk the ESM Member's financial stability (Annex III part. 2). It could be therefore argued that the changes in the PCCL do not have the aim of enlarging the number of countries potentially eligible for the access but to facilitate the access to countries with strong & sound public finances suffering for temporary and unexpected shocks. Countries with more complex and unstable public finances will still have the chance to access a precautionary instrument in form of the ECCL, with the different requirement of a common agreed Memorandum of Understanding acting as a guarantee for all other ESM member states potentially sharing the risks of a loan.

***Monitoring***

As previously mentioned, the ESM reform aims at broadening the competences of the ESM with a deeper inclusion in the Economic and Monetary Union not only as a lender of last resort in times of crisis. After the creation of the EFSF, the ESM has grown as institution and enlarged its competences in assessing debt sustainability and in defining policy measures to ensure better economic conditions. After the ratification of the reform, the role of the ESM in monitoring public finances of its members will be enlarged with a stronger collaboration with the European Commission. In the Joint Position for Future Cooperation between the EC and the ESM the terms of the new, stronger, cooperation are defined to increase the capacity to identify potential risks and to prepare financial assistance efficiently. Policy conditionalities attached to stability programmes will be designed together with the EC and the ECB which will still maintain institutional roles and prerogatives based on primary Union Law as the ESM

remains an intergovernmental organization also after the entry into force of the reform. The cooperation will continue also in the phases of compliance & post-programme monitoring to guarantee correct evaluation and implementation of the adjustment programmes.

The stronger role of the ESM in monitoring public finances sustainability, which will be carried out also preventively and not only in case of a potential intervention of the ESM, has been strongly criticised in Italy as one of the reasons why the reform should not be ratified by the national parliament. Italy has been indeed the only country in which a strong opposition has been observed in the ratification of the treaty, following a similar path as for the Pandemic Crisis Support.

### 4) The ratification of the Treaty and the Italian Case

The ratification of the new reform has not been object of major political debates among the Euro Area since, as described in the paragraphs above, the reform principally had technical features and no relevant political implications. The main development of the reform is indeed the Common Backstop to the Single Resolution Fund which further complete the Banking Union which however has been existing for almost a decade without any negative or controversial effects for any EU member state. The recent sharp increase in inflation rates has endangered many banks worldwide which have registered great losses when in need of liquidity due to higher interest rates of new issued bonds which have reduced market value of previously owned low-paying assets. The failure of Silicon Valley Bank, First Republic Bank, Signature Bank and Credit Suisse in Europe has been a confirmation on the importance of the Banking Union and on how the entry into force of the Backstop would increase trust of financial markets on the solidity of the EU banking system avoiding panic and capital flight from banks in difficulty[130].

[130] Nicolas Véron (2023) The EU ans Swiss messes may nudge the EU towards better international bank capital standards compliance. Bruegel.org

A major debate over the ratification of the ESM reform can indeed only be observed in Italy while all the other 17 Euro Area countries have ratified the reform within January 2022, except from Germany which had to wait for the judgement of its Constitutional Court as six members of the Bundestag asked for a review on the legitimacy of the vote in Parliaments arguing that the ratification of the ESM's reform required a qualified majority in the Bundesrat & Bundestag. The Constitutional Court defined the Constitutional Complaint inadmissible as the reform amending the ESM treaty did not transfer any sovereign powers to the ESM or the EU.[131] [132]

Italy has therefore been the only country in which delays in the ratification of the treaty are related to major political issues and controversies. Greece, considering its hard past during the financial crisis with EU financial regulations and institutions, was among the first countries ratifying the reform with a positive vote in the Parliament only six months after the signature by the government. Spain as well ratified the treaty in November 2021 without any major political turmoil.

### *Italy, Euroscepticism and its difficulty in looking towards the future*

Following declarations of Italian politicians, the main reason why the ratification of the treaty was delayed up until 2023 was the wait for the judgement of the German Constitutional court, but even after a clear green light from Germany, Italy's governmental majority has refused to vote on the ratification and showed strong internal opposition against the ESM reform and the ESM itself as an institution. During the reforming process of the ESM, Italy has had four different governments since 2018 with four different majorities but with a permanent feature[133]: all the majorities included a party with historically *Eurosceptic and anti-austerity* positions, namely Lega, Movimento 5 Stelle & Fratelli d'Italia.

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131 Germany, Federal Constitutional Court (Bunderverfassungsgherícht), judgement of the Second Senate of 13 October 2022, 2 BvR 1111/21, Act of approval to ESM amendments

132 The German Constitutional Court was already involved in 2015 in a judgement over the legitimacy of the ESM: Germany, Federal Constitutional Court (Bundesverfassungsgericht), Judgement of the Second Senate of 12 September 2012, 2 BvR 1390/12 – paras. (1-215)

Between 2018 and 2019, the Italian government lead by Giuseppe Conte with a coalition between the Lega and Movimento 5 Stelle completely switched Italy's position on further developments of the ESM. While the previous government by Gentiloni even proposed a stronger European Monetary Fund to substitute the existing ESM[134], the first Conte government opposed itself against the conditionalities attached to the ESM funds claiming that risk sharing needed to be introduced without the spectre of austerity measures and externally imposed conditionalities. By 2019 the parliamentary debate harshened despite the new government Conte II in which the majority included the Democratic Party which had a positive view over the ESM and its reform. The main opposition came indeed from the Movimento 5 Stelle which published a letter on the newspaper "Il Foglio"[135] explicitly asking not to approve the ESM reform as it did not bring any progress on the fulfilment of the Banking Union and as approving the reform meant making the instrument closer to the country. Despite the strong internal (and external) opposition, Italy finally signed the agreement once the request to remove the mandatory restructuring of the public debt in case of request for ESM support was accepted[136].

Nevertheless, the apparent agreement which allowed the signature of the reform, did not later allow for the reform itself to be ratified from the Italian Parliament. The Government lead by Mario Draghi was voted by the Parliament on 13 February 2021, less than one month after the reform was signed by Giuseppe Conte, but despite the strong pro-European *mark* of the new Italian leadership, the former president of the Europeans Central Bank did not manage to find an agreement within the large parliamentary coalition (the largest in Italy's History) and the ratification passed in the hands of the next legislature which started after the elections of September 2022.

The newly elected parliamentary majority lead by Prime Minister Giorgia Meloni includes both Lega and Fratelli d'Italia, two far-right parties which historically have adopted Eurosceptic position and which, even if subjected to increasing pressure from

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[134] Senato della Repubblica (2018), "Documento XVIII n.232", Senato della Repubblica - Documento XVIII n. 232 - XVII Legislatura

[135] Valerio Valentini (2020), Ecco la lettera dei dissidenti del M5s contro il Mes. La maggioranza ora è a rischio davvero, Il Foglio, | Il Foglio.it

[136] Risoluzione 6-00157 Bonino, Richetti, De Falco

other EU countries, will find great difficulties in ratifying the reformed treaty as many internal defections are likely to happen within the majority.

### *Why Italy?*

One of the main questions which arises from the Italian political context is about the reasons behind the non-ratification of the ESM reform and the political debate which has emerged which is symbolic of a country in which Eurosceptic positions are still very strong and in which the trauma of the 2011 crisis and the risk of an Adjustment Programme has not yet been overcome. Even Greece, which has been the country in which the population has most protested against EU institutions and where the risk of an exit from the EU has been more realistic, has now moved towards political stability and the centre-right Prime Minister Kyriakos Mitsotakis had a great victory at the 2023 national elections with a majority which will allow him to continue its reform plan. At the same time, Alexis Tsipras from Syriza scored only 17,83%, a result which confirms that Greece has now completely closed with its past. An exemplary element of the new Greek attitude towards EU institutions is the delegation of the Greek government to the European Investment Bank to manage € 5 billion of the National Recovery & Resilience Plan "Greece 2.0"[137] to guarantee efficient expenditure of the resources available and comply with Next Generation EU requirements.

Italy, on the other hand, still maintains strong scepticism among its electorate towards EU institutions and the debate on the ESM reform (and the Pandemic Crisis Support) shows this aspect clearly. The evident lack of concrete arguments against the ratification of the ESM reform and the effort to politicize the debate is a signal of a country in which Eurosceptic positions are still attractive for political parties to raise consensus. Italy, unlike countries which were involved in an adjustment programme, did not go through a structural reforming process, as the extraordinary measures to avoid a bailout were undertaken the technocratic government of Mario Monti between 2011-2013 and were not followed by an explicit political intention to address structural

[137] European Investment Bank (2021), Greece: EIB to help manage EUR 5 billion of investments as part of Greek National Recovery and Resilience Plan: "Greece 2.0", eib.org

issues and reforms which still today are needed in Italy as often reminded by the EU Commission.

## 5) Conclusion on Chapter II – Italy & the ESM

The most recent developments of the ESM have shown both the strengths and weaknesses of the institution both on technical and political aspects. The Italian case specifically underlines the importance of the political aspect of every measure and reform undertaken ad European level which may be jeopardized if even a single country decides to oppose itself. The complexity is even greater since opposition may be shown also for purely ideological and political reasons and not necessarily from technical and concrete issues which can be solved by finding a compromise and with effective policy draft which consider the interests and necessities of all countries involved.

The aim of this chapter was a better understanding of the new developments of the ESM and how the new Pandemic Crisis Support and the Reform have been received in Italy. The Italian case is exemplificative of how the Financial Crisis have influenced electors' perception towards European Institutions with effects also on today's EU policy making. While all the countries which experienced an ESM intervention have gone through a period of strong Euroscepticism but now have inaugurated a period of reform, political stability and sound public finances, Italy appears to be a step behind in this process. Paradoxically, the absence of an adjustment programme had negative long-term effect on Italy's attitude towards EU institutions. This negative attitude is still powerful to a point that affects decisions which are clearly in the interest of Italy itself but which, once they enter in to public discourse, become object of fierce debate far from technical aspects and facts.

As described in this chapter, the criticisms against both the reform and the Pandemic Crisis Support hardly find factual confirmation by analysing both the measures themselves and the contextual data. As for the Pandemic Crisis Support, the savings in interest rates were undeniable also during the period of low inflation and the idea of conditionalities as detrimental for Italian people's interests is quite unrealistic. Italy is

indeed a country in which trust towards national government and institutions is very low and there is an historically large scepticism towards politicians' capacity to spend efficiently and responsibly public resources. Consequently, for Italian citizens' best interest, conditionalities should be considered a guarantee that public finances will not be wasted and will be spent for concrete and useful matters. The healthcare system in Italy is increasingly one of the main concerns for Italian citizens and more than € 40 billion of private money[138] are spent each year for healthcare services which the public sector is not anymore able to guarantee. Conditionalities may be bad for politicians whose intention is to use public money to implement short-term view policies in favour of their re-election, but they should be strongly welcomed by citizens as an insurance on the well use of their own tax money.

The SURE instrument was on one hand very efficient in guaranteeing financial stability to workers in a moment of crisis with low interest loans directly by the EU Commission, on the other hand the total lack of conditionalities did not create any incentive for Italy for a reform of its Unemployment Benefits which are largely considered as inefficient as they cause a strong gap between insiders and outsiders.[139]

A similar lesson could be taken from the ESM reform which appears to be criticised for mostly ideological purposes rather than constructive reasons. The timing itself is quite eloquent as the treaty has been signed already by an Italian government and the space for a European-wide debate has been open for more than 4 years, while Italy's strongest opposition has appeared in the ratifying process, where the space for changes and negotiations is permanently closed.

The Italian experience therefore shows the relevance and influence of political discourse and how the different path Italy went through during the financial crisis compared to countries which experienced an adjustment programme has then had consequences on future developments of the European Stability Mechanism. The Pandemic Crisis Support has not been a popular instrument as none of Euro Area

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[138] Istat (2021), Indagine Conoscitiva sulle forme integrative di previdenza e assistenza sanitaria nel quadro dell'efficacia complessiva dei sistemi di welfare e di tutela della salute. (istat.it)

[139] Italy's Unemployment benefits are still mostly based on a system, "cassa integrazione", which was firstly introduced by Henry Ford to face periodic reduction of demand which caused large reduction of needed labour force. Ford understood that it was more efficient to guarantee part of the income for a limited amount of time rather than laying off and re-hire new labour force.

countries decided to access the funds; nonetheless Italy was the country which could have benefitted more in terms of interest rates savings and it could also be argued that financial markets would have considered the request for the Pandemic Crisis Support as a signal of responsibility and care for more sound public finances. Activating the Pandemic Crisis Support may have inaugurated a new period for Italy by taking distance from its hostile tendency towards EU economic and financial policy and would have likely increased trust of financial markets rather than giving a signal of instability. The outcomes of the ratifying process indeed confirm that Italy still has not overcome its negative attitude towards EU financial institutions up to a point at which measures which would be beneficial to all Europe and Italy itself are suspended for political and ideological reasons which decrease the trust of financial markets and EU institution themselves.

# CHAPTER III & Conclusions – The Future

## 1) The Future of the ESM: the Value of Stability in the perspective of a polycrisis

### *A context of Polycrisis*

The term "polycrisis" has become popular in recent year due to its effectiveness in defining a constantly evolving and changing reality where a great number of global risks interact with each other and create a world in which instability is the only certainty[140]. Instability is a great challenge for policy makers especially in economic and financial policy where long-term planning is often made difficult by short-term problems and crisis. In the last decade, the Euro area had to face several different challenges which all had de-stabilizing effects. From the Financial Crisis itself to terrorist attacks in 2015-16, Covid-19, Brexit, Ukraine war, the Energy Crisis and many other. In this new context, the value of stability becomes even more relevant, together with the institutions built to guarantee stability itself, such as the ESM.

### *Covid-19*

One of the main events which has influenced the entire planet with major consequences on the global economy is Covid-19. The Pandemic has caused both healthcare emergencies and related turndown in economic activities which have put under great pressure public finances. The ESM, as described in the previous chapter, played an important role as a European Crisis Management tool showing its

[140] Jonathan Zeitlin, Francesco Nicoli & Brigid Laffan (2019) Introduction: the European Union beyond the polycrisis? Integration and politicization in an age of shifting cleavages, Journal of European Public Policy

Lawrence, Michael, Scott Janzwood, and Thomas Homer-Dixon. 2022. 'What Is a Global Polycrisis?' Version 2.0. Discussion Paper 2022-4. Cascade Institute

adaptability in creating an instrument to help member states to face the health emergency. The Pandemic Crisis Support may appear as an unusual instrument for an institution whose main objective is to guarantee financial stability. Nonetheless, financial stability is influenced by several different dynamics and, during the pandemic, being able to successfully face the health emergency did have a direct effect on economic activities, public finances and therefore financial stability. The Covid-19 crisis showed how important it is to create flexible instrument and institutions to guarantee effective Crisis Management as it is impossible to predict and prevent all potentially de-stabilising events and factors. This lesson is also relevant on a future-perspective as new pandemics are more likely to appear as it was shown by many studies and research due to strong urbanization and increase in world population.

### *Energy, Inflation, Banks*

After more than ten years of low inflation & interest rates, a great number of individuals and policy makers were convinced this financial status was going to last forever[141]. During the first months of the pandemic, national governments dedicated billions of dollars for sustaining the economy in a period of stagnation and the liquidity which became available in the hands of millions of people increased demand in a period where the international supply chain could not cover all the demand, especially for the energy market. The Russian invasion of Ukraine further caused a situation of instability as energy prices increased even more and inflation, already high in the USA, started rising in the European Continent[142].

Consequently, the European Central Bank had to increase interest rates starting from summer 2022 from 0.5% in July 2022 up to 4.25% in August 2023 radically changing a financial context of low interest rates which was enduring since 2009[143]. Higher

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[141] Chamon, Marcos; Ostry D., Jonathan (2021): A Future With High Public Debt: Low for Long is Not Low Forever (imf.org)

[142] Eurostat: Electricity Prices for Household Consumers (europa.eu), ECB: Inflation & Consumer Prices (ecb.europa.eu)

[143] Key ECB Interest Rates (ecb.europa.eu)

interest rates from the ECB meant higher interest rates both for mortgages and government bonds. Many banks have found themselves in need for liquidity and were forced to register great losses by selling bonds and assets with high yields and, as an instance, three mid-sized US banks failed as previously mentioned (Silicon Valley Bank, Signature Bank and Silvergate Bank)[144]. The crisis of Credit Suisse was instead caused by more complex dynamics which have shown the importance of bank regulation and the need for instruments such as the ESM backstop to avoid panic among investors and major cash flows.

The three, interconnected, phenomena of rising inflation, the energy crisis and more recent instability of the banking sector are also an element showing how unexpected changes can always occur and be triggered by exogenous factors such as an energy crisis or a global supply chain crisis after a pandemic and a military invasion.

### *Geopolitics & Climate Change*

Two other major variables which have been now analysed and assessed for a long time for their de-stabilising effect are climate change and geopolitical tensions. Climate change is now showing its first effects with increasing extreme-events and related damages to both people and infrastructures. The transmission channels of climate change risk to the financial sector are now clear and are a major concern both for great financial institutions and Central banks. As the ECB describes, there are two different aspects of potential impact of climate change on the financial sector[145]. Firstly, extreme events can cause great damages to people & infrastructures with direct effects on economic activity; just like the Ever Given cargo-ship caused a major block of the global supply chain by blocking the Suez Canal, a major flood in China may cause damages to a specific industrial district with immediate and direct effect on the entire

144 Rich Barlow (2023): *Why are Banks Failing and Does That Herald Another Financial Crisis?*. Boston University Today (bu.edu)

145 Margherita Giuzio, Dejan Krusec, Anouk Levels, Ana Sofia Melo, Katri Mikkonen and Petya Radulova (2019): *Climate Change & Financial Stability*. (Published as Part of the Financial Stability Review of May 2019)(ecb.europa.eu)

worldwide sector[146]. This aspect of climate change therefore introduces to the second effect of climate change on financial markets, which is rising uncertainty. Uncertainty is both affected by unpredicted events or the uncertainties related to policy measures against Climate Change and how they can shape the entire economic system by introducing new regulation and incentives for new technologies. Specifically, as shown by figure 1, there are sectors which suffer from different exposure to Climate Change risk with direct effect on market development, investments and financial risk[147].

As the ECB states, large financial exposure to climate-sensitive assets of euro area banks needs to be increasingly considered when assessing overall financial risk to effectively allocate risk and avoid unexpected turndowns. The American Federal Reserve also underlines the relevance of acute hazards such as storms, floods or wildfires as revealing events about future economic conditions or the value of real/financial assets. The FED refers to potential "repricing" events caused by large shifts in risk-perceptions or chronic hazards which may change completely and in a short time period the perceptions and evaluations of investors. *Like all financial shocks, it is difficult to predict how and when these broader set of climate risks may be realized as financial shocks*[148].

A specific example raised by the FED is Real Estate[149] which is directly affected by several Climate Change effects such as rising sea levels which may endanger existing structures and require great investments to adapt infrastructure to maintain their usability. The value of coastal real estate could therefore decrease with direct effects on loans, mortgages and mortgage backed securities, increased public expenditures and governments debts to confront climate emergencies. Theoretically, in a perfectly informed market with no externalities, these factors should be already considered while pricing assets, but the uncertain timing of Climate Change effects and low informed

[146] Elisabeth Braw (2021): What the Ever Given Taught the World (foreignpolicy.com)
[147] Giuzio et al. (2019)

[148] Celso Brunetti, Benjamin Dennis, Dylan Gates, Diana Hancock, David Ignell, Elizabeth K. Kiser, Gurubala Kotta, Anna Kovner, Richard J. Rosen, Nicholas K. Tabor (2021): *Climate Change and Financial Stability*. Board of Governors of the Federal Reserve System (federalreserve.gov)

[149] Brunetti et Al. (2021)

markets can cause great vulnerability in the financial system leading to shocks and panic reactions when a region's exposure to climate change risks is more explicitly acknowledged.

(left panel: percentages; x-axis: sectoral contributions to total carbon emissions; y-axis: bank exposures (as a share of total exposures); right panel: Dec. 2015-Dec. 2018; left-hand scale: € billions; right-hand scale: percentage of total holdings)

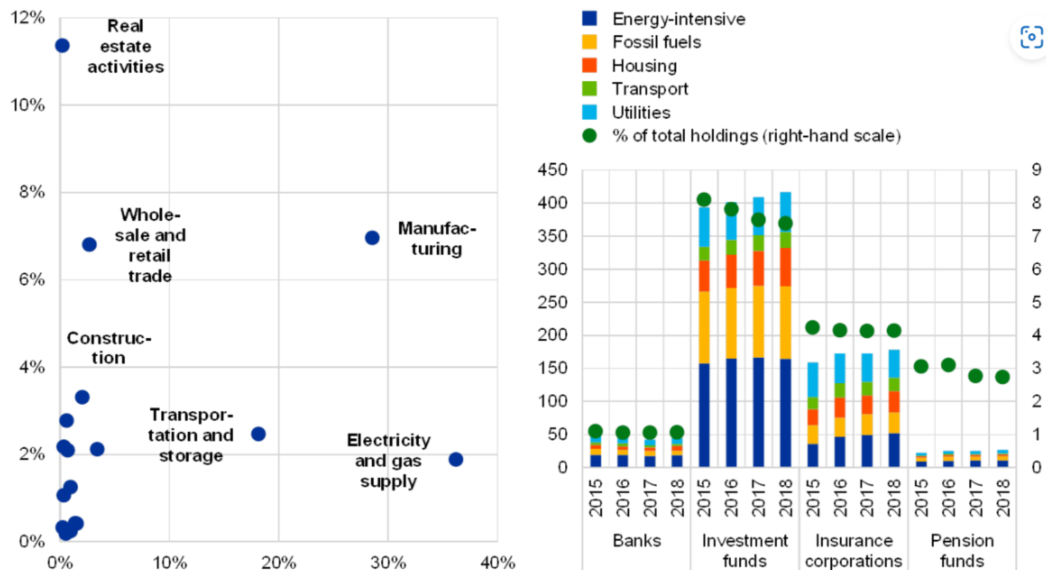


*Figure 9 - Euro Area bank's exposures and sectoral contributions to carbon emissions & evolution of investment exposures to climate-sensitive sectors - European Central Bank*[150]

Geopolitical tensions are instead a factor which has been present for a long time and which have always influenced the choices of investors and risk evaluations. Nevertheless, a globalised economy with a complex and interconnected supply chain tend to suffer more deeply from international tensions and diplomatic crisis between governments and countries[151]. The war in Ukraine is a perfect example as what is concretely a regional war, immediately had major effect on the global economy due to the rising prices of energy and increasing cost of living and manufacturing. The role of energy and related strategic products has been under the attention of investors since the Suez Crisis and the first Oil Shocks of the 1970s, however, the energy sector is not

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[150] Giuzio et Al. (2019)

[151] Fabio Natalucci, Mahvash Qureshi, Luigi Zingales (2023). *Geopolitics and Financial Fragmentation: Implications for Macro-Financial Stability*. International Monetary Fund (imf.org)

the only one which may be affected by geopolitical tensions. The Taiwan-China context is another example of the risk for the entire global supply chain as Taiwan's production of microchips is now fundamental for almost all products on the market. A war in Taiwan or a naval block may affect the entire world production of goods, from the automotive sectors to appliances or sophisticated healthcare machineries which require microchips to be operative[152].

As stated by the IMF itself, geopolitical tensions can cause financial fragmentations with important implications for global financial stability with effects on international payment systems, asset prices and cross-border allocation of capital[153].

*Figure 10 – Geopolitical Risk Index & International Military Conflict with potential de-stabilising consequences on the Financial Sector. Data & Processing from International Monetary Fund.* [154]

[152] Alessandro Aresu (2022): *Il Dominio del XXI Secolo. Cina, Stati Uniti e la Guerra Invisibile sulla Tecnologia.* Feltrinelli, Milano.

[153] Natalucci et Al. (2023), imf.org

[154] Ibid.

## 2) The ESM: born in a crisis, made for crisis

***A new set of European weapons for Crisis Management***

As briefly described in the previous paragraphs, there are a great number of variables threatening financial stability and in a future-perspective those de-stabilising factors will likely increase their influence. Crisis management has therefore increased its relevance in recent years and the European Union itself has gained a pivotal role in addressing emergencies in several different sectors. The financial sector is arguably one of the most integrated and interconnected ones in the European economy due to its natural cross-border characteristics, especially in the Euro Area. This is the reason why regulation of this sector is mostly managed at European Level and, as a consequence, Crisis Management for the financial sector can only be conceived and effective on a European Scale.

Financial Stability is a crucial objective of the EU and all financial institutions work for this objective. From the ECB, the European Commission and the ESM itself which was indeed created in a period of crisis to respond to the need of Euro Area member states for loans at reasonable interest rates when markets could not provide for them. The ESM can be therefore considered one of the most powerful and effective instruments for crisis management both due to its great resources at disposal and its capacity to adapt to different threats as shown for the Pandemic and the Reform which responds to specific necessities mostly for the banking sector.

Considering the banking sector as an example, the recent instability caused by rising inflation and interest rates, high energy costs affecting especially economic activities and vulnerable citizens and the reduction of great purchases programmes by the ECB have not caused de-stabilising consequences for the banking sector[155]. Considering a

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[155] ECB Press Release (2023) : Stress Test Shows Euro Area Banking Sector Could Withstand Severe Economic Downturn (bankingsupervision.europa.eu)

ECB Banking Supervision (2023): 2023 Stress Test of Euro Area Banks, Final Results. (bankingsupervision.europa.eu)

situation such as those of Silicon Valley Bank or Credit Suisse, the Single Resolution Fund and the Backstop provided by the ESM reform (although still not ratified) would have likely decreased the chance of rising panic among investors and withdrawals from bank accounts. In addition, the strong banking supervision guaranteed by the Banking Union would also have avoided many of the risk-taking behaviours of the banks and avoided non-transparent conduct (especially considering the case of Credit Suisse)[156]. The effectiveness of institutions or policies such as the ESM and the Banking Union can be therefore observed firstly in their role in avoiding crisis at first by avoiding de-stabilising factors such as panic, lack of transparency and moral hazard. Secondly, if a crisis does erupt, the emergency instruments are in place and ready to quickly respond and enter into force.

The role of crisis in the European Integration Process has been largely assessed by both historians and politicians[157]. Jacques Delors himself has dedicated many of his writings to assess the impact of crisis as critical junctures which have provided for the necessary impulse for important decisions and developments[158]. From the empty chair crisis to the effort to relaunch the integration process in the 1980s and the first debates and measures to introduce the single currency, it is from great difficulties and complex historical moments that the European Integration process has shown its resilience and its strength, offering alternative solutions and space for improvements which went much beyond the temporary needs to face a single issue. The Financial Crisis is indeed one of those critical junctures and it has had an unprecedented impact on European Integration history: the European Central Bank has become, together with the Federal Reserve, probably the most important financial institution worldwide with the capacity of pursuing an autonomous and ambitious monetary policy and with the power of

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[156] Owen Walker & Stephen Morris (2023): Credit Suisse: the Rise and Fall Of The Bank That Built Modern Switzerland. Financial Times (ft.com)
Daniel Davies (2023): Swiss Regulators Need To Face Up to Credit Suisse Failures. Financial Times (ft.com)
[157] Dinan, Desmond & Nugent, Neill & Paterson, WilliamE & Schimmelfennig, Frank. (2017). Theorising Crisis in European Integration.

[158] Jacques Delors (1994) European unification and European security, The Adelphi Papers, 34:284, 3-14

Jacques Delors (2013). Economic governance in the European Union: past, present and future. Journal of Common Market Studies, 51(2), 169-178

going against the political position of Germany on a matter such as monetary policy itself, something unthinkable only 5 years before[159].

The ESM too has been part of this *revolution* and, as such, it embodies the ambitiousness and the long-term vision. The ESM was not built as a temporary instrument to help four countries in difficulty. Member states could have agreed to create a temporary intergovernmental facility such as the Troika to guarantee bilateral loans and, once the crisis was over, no important developments would have been achieved on a future-perspective.

A facility such as the Next Generation EU has in its core the same principle of solidarity and shared responsibility which was firstly successfully introduced with the ESM which has therefore opened for new perspectives not only in the area of financial and stability policies.

***The European Monetary Fund***

The First proposal for a European Monetary Fund was advanced by Daniel Gros & Thomas Mayer in 2010, even before the creation of the ESM and the EFSF[160]. The main idea was the creation of a new institution which would avoided the intervention of the IMF (a powerful institutions in terms of financial resources but weak in its instruments at disposal other than strong austerity and fund-retirement) and would have improved the weaknesses of the EU Commission (limited funding and political constraints) by maintaining its strengths (expertise, possibility to mutualize risk, different areas for political pressure and democratic legitimacy). Gros & Mayer, publicising their paper in February 2010, anticipated the potential risks of the participation of the IMF to an adjustment programme and the lack of a specific

[159] Specifically referring to the approval of the Quantitative Easing which initially was opposed by the German Member in the Board of Directors of the ECB

[160] Gros, Daniel and Mayer, Thomas (2010): Towards a Euro(Pean) Monetary Fund. CEPS Policy Brief No. 202

European institution to deal with the risk of default. The proposal basically introduced the idea of an ESM-like institution which was then developed in the next years.

Subsequently, the proposal for the European Monetary Fund was viewed as a further step in the integration of the ESM in EU institutions and as an enlargement of its competence and structure[161]. Wyplosz imagined in 2017 an EMF structured in directorates as the IMF, included in EU legislation and with a stronger autonomy also in terms of relationship and accountability to European citizens and not only to its governmental shareholders. The advantage of having the EMF would not only be the strengthening of the ESM, but also the political autonomy of not requiring the intervention of the IMF which is often considered as not having the resources to deal with the need of advanced economies such as those of the EU.

Klaus Regling himself in an interview in 2017 has underlined that the greatest advantage in setting up an EMF would be in terms of more efficient and effective governance[162]:

*"One reason to transform the ESM into an EMF is to improve governance. The overly complex, and at times counter-effective, arrangement adopted in the midst of the crisis is the result of conflicting viewpoints and interests that are not likely to be easily brushed aside. This calls for careful and rigorous preparations. Governance must be designed to cope with a number of issues previously mentioned and now examined in more detail."*

EU institutions themselves, when the debate for an ESM reform started in 2017, initially supported the creation of the EMF rather than a *simple* reform of the ESM. Only the Council, as representor of national governments will, opposed itself by pressuring for maintaining the intergovernmental nature of the institution. In its proposal of January 2017[163], the EU Commission formally proposed the establishment

161 Wyplosz, C. (2017): A European Monetary Fund?, EPRS: European Parliamentary Research Service. Belgium

162 Klaus Regling in Interview with le Figaro (2017) (esm.europa.eu)

163 European Commission (2017): Establishment of a European monetary fund (EMF) - COM/2017/0827 final - 2017/0333

of a European Monetary Fund to integrate the ESM in EU legislation to further integrate the Euro Area, guarantee stability and prosperity and to strengthen Europe's voice on the global scenario. Following the Commission's proposal, most of the characteristics of the ESM would have been maintained and the fund would have not been linked in any way to the European Union budget. The € 60 billion backstop to the Single Resolution Fund would have also been included as in the reform but greater changes would have been included in the governance, with the introduction of a qualified majority of 85% replacing unanimity. The introduction into EU law would also mean a different role of national parliaments which would not have had anymore veto powers such as the Bundestag and the EU parliament would have played a pivotal role with the Council in accountability of ESM's decisions.

However, the proposal for a European Monetary Fund had two main issues to confront in order to go forward. The first issue was political: while EU institutions positively viewed a more autonomous structure and decision-making of an evolved ESM, member states would have hardly accepted such delegation of powers in a delicate matter such as financial stability unless great advantages were guaranteed by the creation of the EMF. This element brings us to the second issue which is more related to the characteristics of the EMF and the advantages brought by its creation: the main reason for the creation of the EMF was the exclusion of the IMF from hypothetical future adjustment programmes but this would have required the creation of a much more complex and large institution which had to rapidly learn how to effectively fulfil its tasks and work closely with the entire Eurosystem[164].

***Other Proposals***

The proposal for a European Monetary Fund has been the only main alternative to the current ESM and the reform which is yet to be ratified. Another interesting idea which has been often proposed in recent years both by the Academia and EU politicians is

[164] Wyplosz (2017)

for the introduction of a Eurozone Finance Minister[165] which would also change the role of the ESM itself by guaranteeing more autonomy to the institution.

The Eurozone Finance Minister would have a pivotal role in Eurozone Crisis Management to avoid fragmentation and guarantee effective and immediate decision making without the intermediation of national governments which could lead to delays and disagreements. The ESM would therefore increase its autonomy from the vetoes of National Parliaments and would work more closely to the ECB by designing coordinated action and the European Parliament would guarantee democratic accountability of decisions undertaken by the finance minister with the ECB and ESM. Klaus Regling himself has confirmed the potential positive effect of a finance minister not only in the coordination of economic policies but also in representing the Euro Area and its interests in international bodies such as the G20 and the IMF[166].

Other instruments have been proposed[167] to improve the economic stability, integration and growth of the EMU such as the creation of common budgetary instruments co-financed by Eurozone countries with coordinated governance to cover for the limited capacity and resources of the Multiannual Financial Framework. While the ESM, due to its great financial resources, is often mentioned as an instrument to integrate in the future-budgetary perspectives for a more integrated Europe, it is important to underline that even a strongly reformed ESM or a new EMF cannot cover for any budgetary needs other than those occurring for emergencies and threats to financial instability. The credibility and trust towards the ESM on financial markets are guaranteed by this basic principle; an amended ESM in order to cover for ordinary budgetary needs would lose its credibility and therefore could not guarantee such favourable conditions to a country facing financial instability or even the risk of default.

[165] Guntram B. Wolff (2017): What a Euro-Area Finance Minister Mean? (Bruegel.org)

[166] Regling (2017)

[167] Ole Funke, Lucas Guttenberg, Johannes Hemker, Sander Tordoir (2019): Finding Common Ground, A Pragmatic Budgetary Instrument for the Euro Area. Jacques Delors Institute, Berlin (delorscentre.eu)

### 3) The Obstacles to overcome, a lesson from the past for the future

***The lesson from Italy: the trauma of the financial crisis still exists***

As seen in Chapter II describing the Italian experience with the ESM reform and Pandemic Crisis Support, one of the main obstacles which can appear during a reforming process or an effort to deepen integration in a specific policy area is the veto action of a member state due to internal discontent over European Institutions.

While the strong wave of Euroscepticism appears to be ended in all the countries in which adjustment programmes were implemented, the political consequences of the Financial Crisis still have a strong influence on Italy's political parties due to trauma still present on public opinion. The strong opposition towards the ESM reform and the ESM itself as a financial institution is a symbol of Italy's still unresolved marriage with EU financial institution and their democratic accountability. As shown in Chapter II, this is the main plausible reason explaining Italy's refusal to ratify the reform as political parties still seek consensus among electors by adopting veto-actions towards EU economic and budgetary policies. Other technical reasons against the reform proposed by members of the majority appears inconsistent and a hypothetical political strategy behind the non-ratification to obtain other concessions on Eu financing is simply unrealistic or even counterproductive. The same Ministry of Economy and finances, whose Minister is a member of the majority, has confirmed that the ratification of the reform does not cause any damage to Italy's financial position and that it can only have positive effect on interest rates of public debt due to increased trust of financial markets[168].

Despite more than ten years have passed since the first rescue programmes, the financial crisis still is a crucial event to consider explaining today's political context and to understand both the concrete perspectives of future improvements of financial integration and what is the better strategy to achieve them without the risk of veto-action of single member states. At the same time, as shown in chapter I, the financial

[168] Valerio Valentini (2023): "Ratificare il MES Conviene all'Italia", Un Documento di Giorgetti Inguaia Meloni. Il Foglio, Roma (ilfoglio.it)

crisis had a negative effect on public opinion also in Northern European countries which started to see southern EU countries as irresponsible and as profiting from the stability of the euro guaranteed by their participation to the common currency. Considering the creation of the ESM, for instance, German citizens initially did not strongly support the initiative and a polls showed that 54% of them hoped the Constitutional Court would block the ESM.[169] [170]

### *The role of communication: more direct involvement of public opinion rather than counting on national politicians as intermediaries.*

Communication is one of the most important factors to consider and manage to guarantee the success of a specific policy measure. European Institutions, especially in the sector of financial policies, often do not manage to propose and establish their own communication strategy and to reach autonomy on member states' media networks[171]. Most of the time EU institutions count on the intermediation of national governments and institutions which often have different positions and interests and often cause distortion in public opinion's view and attitude towards EU institutions. This is particularly true for financial institutions which, at EU level, find two great difficulties in the communication strategy. The struggle of being an EU institution trying to find a space to communicate with citizens is added to the complexity of the topics and themes which are object of debate.

The more intermediaries, the more space to distort information and mislead and the more chance for speculators to act. The Italian experience with the ESM is the perfect example of this dynamic: if only technical reasons and national interests are considered, the general unpopularity of the instrument and the refusal to ratify the reform and

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[169] Der Spiegel (2012): Mehrheit der Deutschen hofft auf Sieg der Euro-Gegner. (spiegel.de)

[171] Belluati, M. (2021). The European Institutions and Their Communication Deficits. In: Newell, J.L. (eds) Europe and the Left. Challenges to Democracy in the 21st Century. Palgrave Macmillan

access the Pandemic Crisis Support would be almost impossible to explain as they would appear as totally non-rational choices. However, if we observe how the ESM (and other financial institutions) have been described and narrated in Italy for years, everything starts to make sense. A strongly negative narrative has developed from the years of the financial crisis and the criticism towards the European Union have often been an instrument for political consensus both to avoid responsibilities and to have a scapegoat for worsening of economic conditions. The lack of an effective counter-narrative from representors of EU institutions and the lack of representation on national media increased the space for this dynamic which is still relevant and still have concrete consequences.

Charles Wyplosz writes that a central bank can only be independent if it earns the support of the public opinion and that if there are different public opinions that follow national lines this becomes mission impossible[172]. Wyplosz therefore identifies a fundamental precondition for effective actions of EU financial institutions: support of public opinion. Support from public opinion hardly arrives if there is a deficit in communication and citizens are not directly reached by those institutions themselves to guarantee more awareness and leave less space for populist narratives and misinformation.

[172] Wyplosz (2017)

## Final Conclusions & Remarks

The European Stability Mechanism, despite not being among the most widely known institutions of the Euro System, has certainly played a fundamental role during the financial crisis in mitigating the financial situation of five member states and, since then, has become an indispensable guardian and guarantee of financial stability for the entire continent. As shown in the first chapter, the importance of the ESM is underlined both by its technical aspects but also by the political significance of its establishment. Considering the situation of crisis in which it was created and the strong disagreements among member states during the initial phases of the financial crisis, the resulted ESM is an extraordinary example of political ambitiousness and spirit of solidarity. For this reasons, the ESM still plays a central role as a European Institution as it still remains the only stable instrument of financial solidarity and shared responsibility between member states. Instruments such as SURE and the Next Generation EU, although they received much stronger attention and support among public opinion, only have a temporary structure unlike the ESM, which has evolved in the meanwhile and is likely to further evolve in the future by increasing its capacity and adaptability to different situation of crisis and need.

Despite initially being born with a very specific purpose it has become a stable instrument with the transition from the EFSF to the ESM and it has also developed in time by offering a concrete financial response to the Covid Crisis and through a reforming process which will further increase its efficacy and will be an important insurance for the banking sector once the ratification procedures will be completed.

The *Present* of the ESM has therefore shown that it can be a powerful instrument to face future challenges and that, with the necessary ambitiousness and political willingness like those shown during the creation of the ESM itself, it can furtherly be reformed and improved. Its technical nature can be considered an advantage in situation of crisis, as it can help overtake potential political clashes delaying the necessary actions as happened during the first Greek Bailout with the additional risks of a hostile climate among member states focusing on protecting national interests rather than enhancing a spirit of solidarity.

Nevertheless, it is not a perfect instrument and there is still great space for improvements which can reach far beyond the reform itself. As previously shown, one of the main potential obstacles to any ESM intervention or evolution is its public perception among member states and electorates which needs to be radically improved through innovative and alternative communication strategies. The principles of solidarity and shared responsibility, which stand to the foundations of the ESM, need to be acknowledged and emphasized and a new narrative over ESM interventions during the financial crisis needs to be created, especially to separate the institution from the negative reputation of the Troika. Another crucial point for the future of the ESM is its integration in the broader Economic and Financial policies and institutions of both the European Union and the Euro Area. As shown in chapter III, the challenges ahead will furtherly stress the stability and growth of the entire European Union and the entire set of financial institutions must be able to cooperate and intervene to address crisis situations and guarantee immediate and coordinate responses. The ESM plays a fundamental role in this context both as an institution which already can count on shared resources raised among its member states and as it has already demonstrated in the past its effectiveness in acting as a financial guarantee or by directly borrowing money on the market in situations of emergency.

To conclude, the analysis carried out in this thesis starting from its past and creation to its more recent developments has shown the results achieved by the European Stability Mechanism and its most important and defining characteristics as the lender of last resort of the Euro Area. Those technical aspects have been contextualised also considering a political perspective and a discourse analysis to propose a more comprehensive and alternative point of view of the ESM and its meaning which, as shown in the three chapters, goes far beyond the articles of its establishing treaty.

The ESM shows how contrasting national interests and positions can be harmonised when something greater is at stake and how solidarity can arise in the European Union in the hardest moments of apparent impossibility to find a compromise and a shared solution.

The ESM is probably not one of the most analysed, discussed, understood and appreciated EU institution, but it certainly is a great example of the extraordinary power and spirit which Europeans, united, can achieve, overcoming apparently insurmountable obstacles.

This has been true in the past, in the present, and it must be true for the future.

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4) Banco de Espana, General Government Statistics (BdE)

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