European Monetary Union in the crisis
The role of ECB and
the European Stability Mechanism (ESM)

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“A monetary union with a stable euro can only survive if central bank independence is fully respected. This implies that the ECB abstains from fiscal policy actions *(such as the Securities Market Program = SMP)***. Yet to change the “no bail-out” clause ever more in the direction of a bail-out regime is not a step towards a democratically-legitimised political union.”**

Otmar Issing (FT August 8, 2011)

“No-Bail-Out”-Clause

Art. 125 Sec. 1 Treaty on the Functioning of the EU

The Union shall not be liable for or assume the commit-ments 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 under-takings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.

Prohibition of Monetary Finance

Art. 123 Sec. 1 Treaty on the Functioning of the EU

Overdraft facilities or any other type of credit facility with the European Central Bank (…) in favour of (…) governments, regional, local or other public authorities, other bodies governed by public law or public undertakings of Member States shall be prohibited, as shall be the purchase directly from them by the ECB (…) of debt instrument.

How do states finance government spending?

- **Taxes (royalties, income from public enterprises etc.)**
- **Borrowing money:**
  - **through loans (rarely in developed economies)**
  - **through issuing sovereign bonds in capital markets (primary market)**

How does a sovereign bond work?

- Investors buy the bonds when they are first issued.
- Purchase price is equivalent to the funds borrowed in case of a loan agreement.
- State pays periodically interest to the bondholders. The interest rate reflects the country risk.
- Once the pre-determined maturity of the bond is reached the state pays the face value (typically equal to the purchase price) of the bond to the bondholders.
- In the meantime bondholders can sell the bond on a stock exchange.

Do states really pay back the face value of bonds?

- Technically yes, if its not Argentina!
- Economically no, not even the USA or Germany.
- States "roll" their debt!

  As soon as the maturity of an old bond is reached they issue a new bond.
- Pre-condition for "rolling":

  There must always be a sufficient number of buyers/investors ready to purchase the new bonds for a reasonable interest rate (more then 6 or 7% p.a. are is not sustainable).

Who determines the interest rate?

- The issuer, but based on what the market requires!

- Price information emerge in the secondary market:

face value (purchase price)	= 100 Euros
interest rate	= 3% p.a.
maturity	= 10 years
after 3 months an investor needs to sell for only	= 80 Euros

- Buyer in the secondary market gets 3.75% p.a. for its investment

- When issuing a new bond (equivalent to the old one) the state must now offer at least 3.75% p.a.

What happens if there are no sufficient buyers?

- Rolling of debt does not work, or only if a prohibitive interest rate is offered.

- A buyer of last resort is needed to bring the interest rate down.

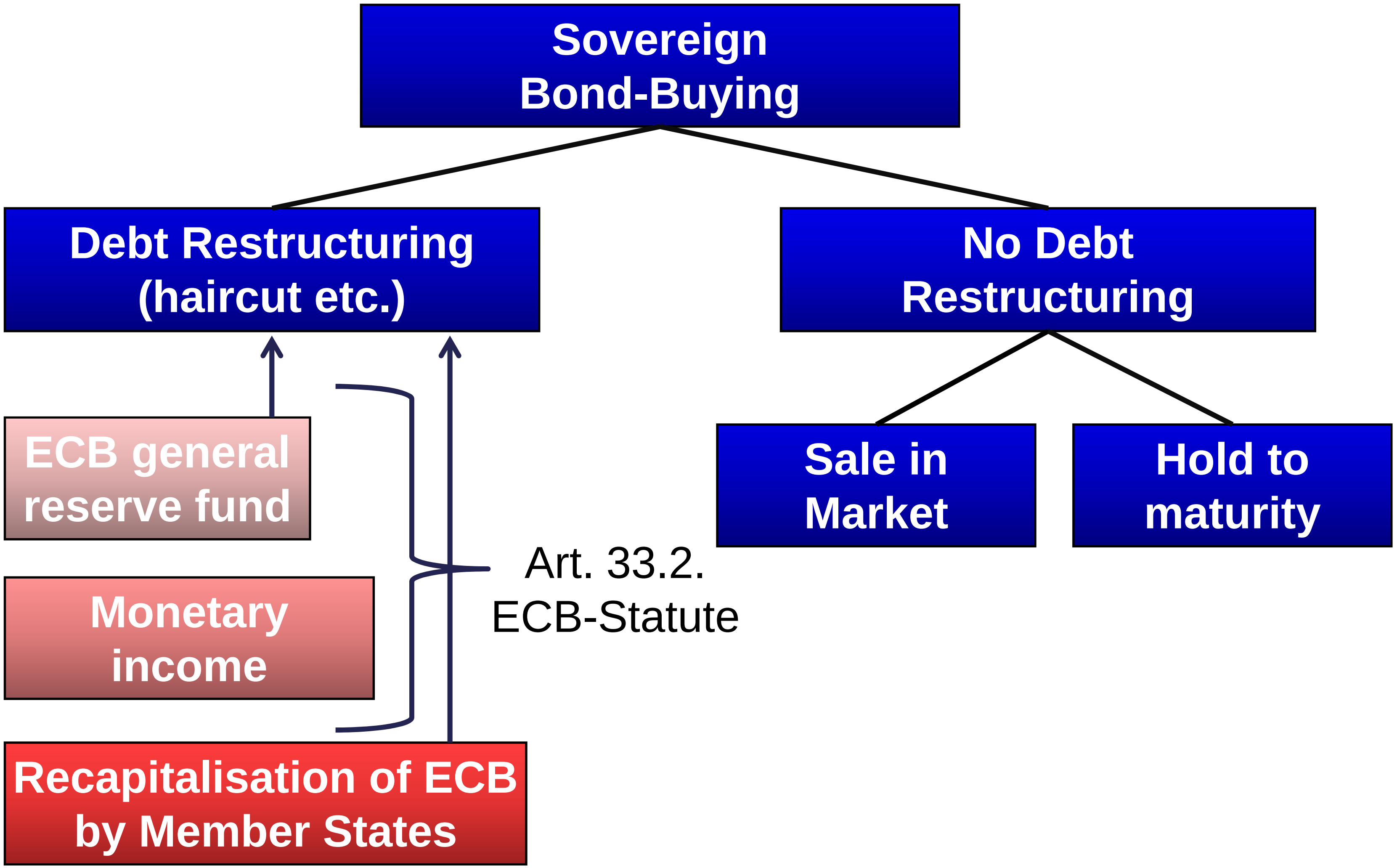
- Who can play the role of buyer of last resort?

  - the central bank, or

  - a special rescue fund

- The ECB launched a so-called Securities Market Program and bought sovereign bonds of Greece, Ireland, Portugal, Spain and Italy.

Risks caused by the SMP



Negative Consequences of the SMP for the ECB and its independence

- **Mounting political pressure on ECB in case a sovereign default (waiver, haircuts).**
- **Need to absorb loses arising as a consequence of the SMP.**
- **Monetary stability depends on fiscal discipline, but SMP creates moral hazard in over-indebted member states.**
- **Legal uncertainties:**
  - **conflict with "no bail out“ clause**
  - **conflict with prohibition of monetary financing**

Legal Basis for SMP (according to ECB/2010/5)

- **Art. 127 (2) TFEU (equivalent to Art. 3.1 ECB-Statute):**

  The basic tasks to be carried out through the ESCB shall be:
  - to define and implement the monetary policy of the Union.

- **Art. 12.1 (2) ECB-Statute:**

  The Executive Board shall implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council. In doing so the Executive Board shall give the necessary instructions to national central banks. (…)

- **Art. 18.1 ECB-Statute:**

  In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may:
  - operate in the financial markets by buying and selling outright

Legal Basis for SMP (according to ECB/2010/5)

- **ECB-Decision May 14, 2010 (ECB/2010/5):**

  “in view of the current exceptional circumstances in financial markets, characterised by severe tensions in certain market segments which are hampering the monetary policy transmission mechanism and thereby the effective conduct of monetary policy oriented towards price stability in the medium term, a temporary securities markets programme (…) should be initiated.”

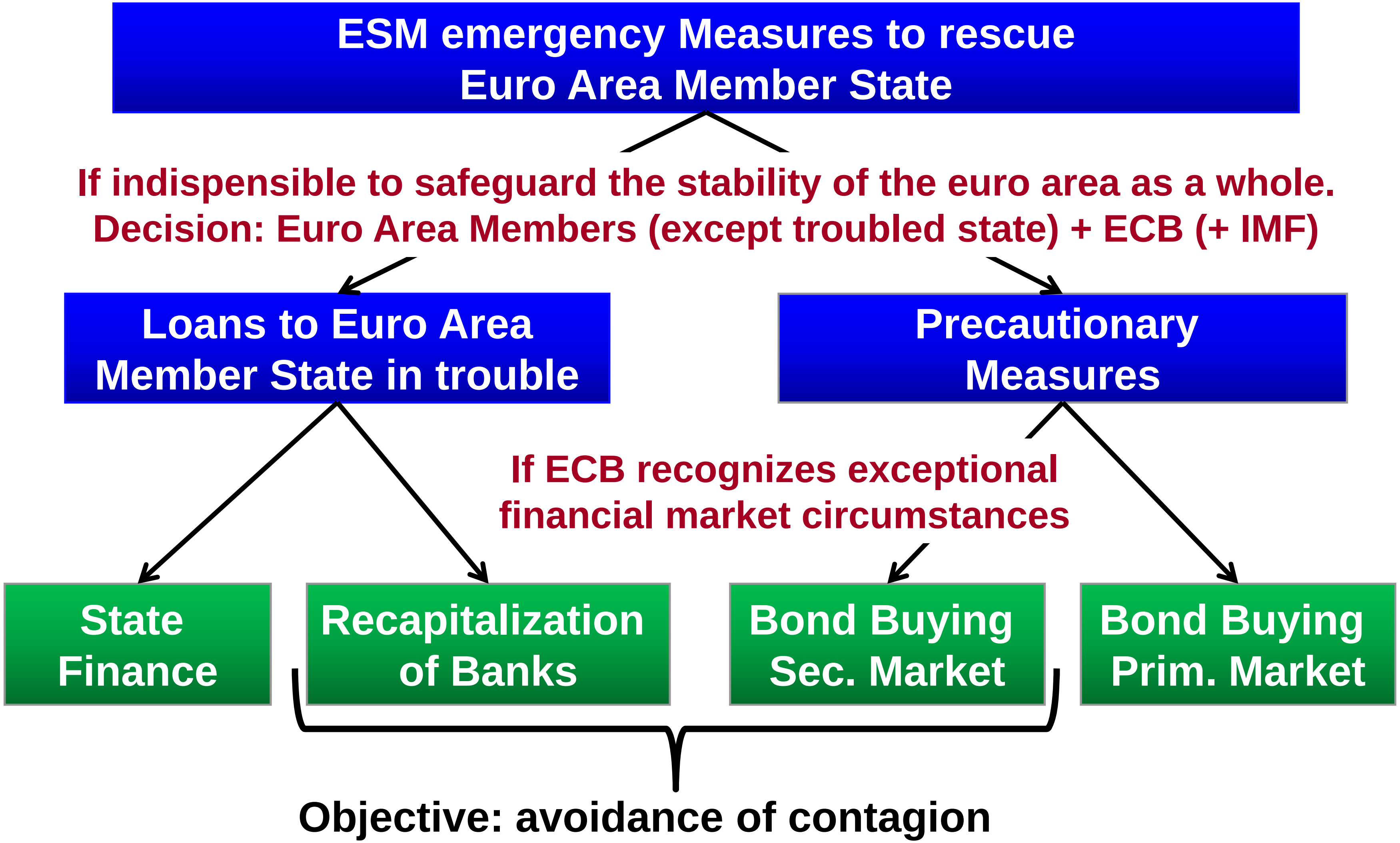
- **Art. 12.1 (1) ECB-Statute:**

  The Governing Council shall formulate the monetary policy of the Community including, as appropriate, decisions relating to inter-mediate monetary objectives, key interest rates and the supply of reserves in the ESCB, and shall establish the necessary guidelines for their implementation.

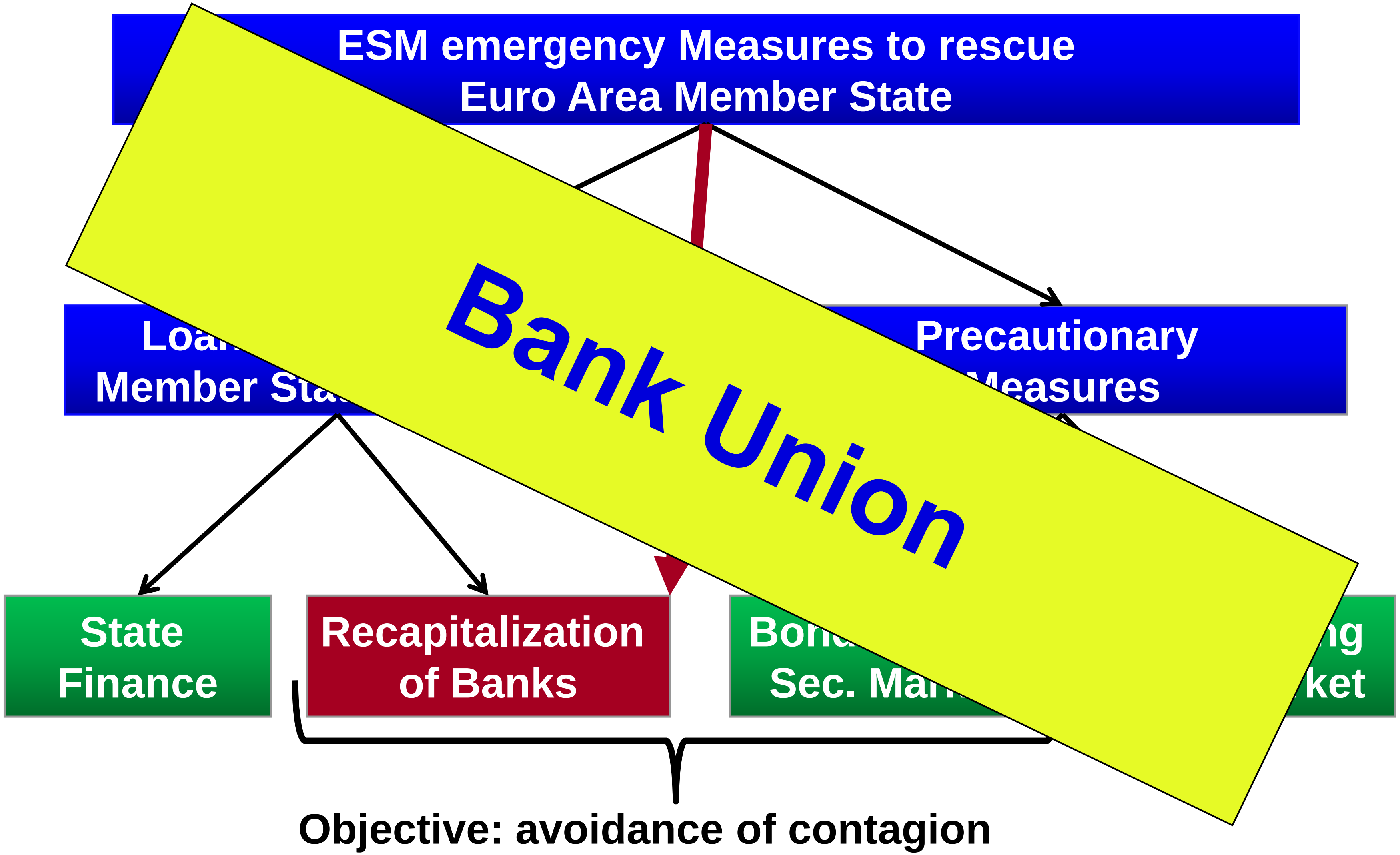
Establishment of the ESM

- **Instruments of the ESM**
- **Legal bases of the ESM**

The instruments of the ESM



Extension of ESM instruments



Revision of the TFEU (the new Art. 136 III)

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.

Simplified revision of the Treaties (Art. 48 IV TEU)

The decision referred to in the second subparagraph shall not increase the competences conferred on the Union in the Treaties.

Simplified revision of the Treaties (Art. 48 IV TEU)

- **ESM is not an institution established by the Treaties of the European Union**
- **It is an intergovernmental institutions outside the Treaties.**
- **Legal construction:**
  - **a *société anonyme* incorporated in Luxembourg**
  - **full legal personality and capacity**
  - **contracting parties (eurozone countries) as shareholders**
  - **exempted from any requirement to be authorized or licensed as a credit institution, investment services provider or other authorized licensed or regulated entity**

Rational and shortcomings of the institutional structure used for the ESM

- **Rational of the institutional shift ("outsourced institutions"):**
  - **Lack of time to amend the treaties.**
  - **Political risk inherent in each alteration of the treaties.**
- **Shortcomings of the institutional shift:**
  - **Need to redesign the ESM (after only one year) via mutual consent of 17 national governments and parliaments.**
  - **Unclear relation to other EU institutions (ECB) and provisions of the European Treaties (no-bail-out).**
  - **Lack of democratic control on EU level.**

Thank you!