Europe's common financial response to challenges: what has already been done

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Tackling Europe's challenges of today, such as climate change and geopolitical risks, has spurred increased calls for additional common financing schemes. In this blog, we look at how existing capital structures can play a role. Countries have increased their support for common debt issuances over the last 15 years, driven by the responses to the euro debt crisis and the Covid-19 pandemic. While the size of commitments and liabilities has increased, funds are still available, creating a unique opportunity to make efficient use of them.

Start where you are, use what you have, do what you can

The European Union's (EU) common challenges, such as the transition towards a green, sustainable and digitised economy, disruptive climate events, and increased defence spending needs, have motivated growing calls for additional joint European issuances to address them. Recent history shows that funding through European institutions has positive results.

While these urgencies justify co-ordinated action, resources to address them are already available in Europe. Funding initiatives based on common debt or guarantees have existed for some time and can offer support to a wide range of needs. Since 2012, the authorised and consumed capacities of common lending schemes have risen considerably, though a large part remains untapped. According to latest data available, in 2022, only 36% [1] of the fixed authorised lending capacities available to EU and euro area members had been used.

Through the EU, many programmes can lend directly to members. These include, for example, the Recovery and Resilience Facility created to mitigate the impacts of the Covid-19 pandemic and to support long-term growth. Similarly, the EU has set up initiatives to aid the green transition, and foster development through instruments known as budgetary guarantees. [2] The European Investment Bank provides funding to projects under its own framework outside of joint schemes for lending to sovereigns.

The European Stability Mechanism (ESM) can lend to euro area member states to address threats to financial stability with a current lending capacity of EUR422 billion. The ESM provided loans as part of macroeconomic adjustment programmes during the euro area crisis. In addition, the ESM has precautionary instruments that countries can access before a crisis occurs. The ESM thus also plays an important preventive role that contributes to the euro area's resilience in the longer term, acting as an additional safety net for countries as they face challenges such as geopolitical and climate risks, which could endanger financial stability.

No free lunch, new joint solutions require robust support

Being efficient with the resources available today is critical given how joint solutions are funded. Common financing schemes require robust capital structures to be effective, and these structures always come at a cost. These structures serve the purpose of reassuring investors that they will be repaid even in the unlikely event of a default on outstanding loans. To this end, common financing schemes in Europe rely on support from either national or EU budgets. In addition, they always include a credit enhancement to obtain high credit ratings, which unlocks funding access at favourable terms.

EU loans to Member States are covered by a guarantee made by all EU countries through what is known as the EU budget headroom. [3] As a first line of defence, however, the EU's available resources would be used to service a liability directly, should it manifest. The ESM's financial strength derives from its subscribed capital of EUR708.46 billion, of which EUR80.97 billion were paid in by the euro area member states with the remainder committed as callable capital. Conversely, the European Financial Stability Facility (EFSF), the ESM's predecessor, has a low paid-in capital while its debt is guaranteed by euro area member states.

Government guarantees grow in step with joint schemes

Common lending schemes created within the last 15 years resulted in a substantial increase in European contingent liabilities dedicated to their backing (See Figure 1). For example, to support the instruments created to address the economic consequences of the Covid-19 pandemic, the EU budget headroom was increased temporarily by 0.6% of EU gross national income. Similarly, the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency, created to support pandemic-era labour market measures, benefitted from additional Member State guarantees to top up those made through the EU budget.

Figure 1: European contingent liabilities on the rise

(in % of EU GDP)

Notes: Budgetary guarantees include the European Fund for Strategic Investments, European Fund for Sustainable Development, the External Lending Mandate, the European Fund for Sustainable Development Plus, and InvestEU. This also includes the pan-European Guarantee Fund which involves Member State guarantees provided directly to the European Investment Bank. EU Member State loans include the Balance of Payments Facility, Recovery and Resilience Facility (loans only), and the European Financial Stability Mechanism. EU Loans to third countries include Euratom and the European Commission's macro-financial assistance.

Sources: European Commission and ESM

Though a rise in common challenges motivates the creation of new common financing schemes, this approach can squeeze members providing support and could put undue pressure on countries with already limited fiscal space. The proliferation of ad-hoc solutions for emerging crises poses problems of both financing and legitimacy.[4] A recent European Court of Auditors report has highlighted the need for adequate prior assessments in both design and options for all new instruments within the EU. [5]

Whilst the challenges Europe is facing and the resulting financing needs may increase further, the critical question of the financing structures needed to overcome these challenges should not be overlooked. These concerns, relevant not only for Europe but also for the wider global financial system,[6] make the case for using existing and available lending capacity.

While urgencies require effective solutions in the short term, the efficiency of joint funding solutions is also a long-term question. National and EU budgets alone cannot carry the burden of absorbing economic shocks that may hit Europe in the future. Initiatives to strengthen capital markets union, which are at the top of European policymakers' agendas, will increase cross-border private risk-sharing, making Europe more resilient and thereby supporting a more efficient use of common funding schemes.

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Further reading

Reports from the Commission to the budgetary authority on guarantees covered by the general budget Situation at 31 December 2007-2008

Reports from the Commission to the European Parliament and the Council on guarantees covered by the general budget Situation at 31 December 2009 to 2019

Reports from the Commission to the European Parliament and the Council on financial instruments, budgetary guarantees, financial assistance and contingent liabilities Situation at 31 December 2020 to 2022

Anev Janse, Kalin; Strauch, Rolf, "How capital market finance can boost European businesses "

Footnotes

[1] Ratio between the consumed and authorised lending capacities of instruments with fixed lending capacities which can lend directly to EU or euro area members. These include instruments with available lending capacity: the Recovery and Resilience Facility, the Balance of Payments Facility, and the ESM as well as those instruments where no new loans can be disbursed: the Support to mitigate Unemployment Risks in an Emergency instrument and the European Financial Stability Facility. The European Financial Stability Mechanism's lending capacity is assumed to be fully used. Recovery and Resilience Facility lending capacity is set at EUR360 billion in 2018 prices and assumed to remain constant between 2021 and 2022. The legal deadline for Member States to request loan support at the time of the submission of a revised recovery and resilience plan was 31 August 2023.

[2] Examples include InvestEU and the European Fund for Sustainable Development Plus.

[3] The EU budget headroom is the difference between the maximum amount of funds that the EU can request from Member States to cover its financial obligations and the maximum amount of funds that can be spent in a given period. Its size is established through the Multi-annual Financial Framework.

[4] Begg, I. (2023). The EU's increasingly complex finances: A ticking bomb?. In EconPol Forum (Vol. 24, No. 4, pp. 16-20). Munich: CESifo GmbH.

[5] European Court of Auditors (2023). The EU's financial landscape, A patchwork construction requiring further simplification and accountability

[6] As an initiative of the G20, An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks was conducted in 2022, investigating the scope for improving capital efficiencies within multilateral development banks for which a roadmap to implement the subsequent recommendations was agreed upon by the G20 in July 2023.