European Stability Mechanism
The Wharton School - Lecture

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What is the European Stability Mechanism?

- ESM founded in 2012 (EFSF est. 2010)
- International Financial Institution, similar to IMF, WB and EBRD
- EFSF/ESM combined balance sheet of €970 bn ($1.1 tn)
  - Larger than the IMF, WB, EIB, AIIB and similar institutions
- ESM paid-in capital: €80 bn
  - Paid-in capital largest of any International Financial Institution worldwide
  - Invested in high quality, secure and liquid assets
- To date, we disbursed over €245 bn in loans
  - About three times more than the IMF disbursed globally in the same period
- ESM and EFSF issue €50-80 bn in bills and bonds a year
  - 5th largest euro denominated issuer in 2013
- Our uncommitted lending capacity is €370 bn

ESM Board of Governors (Euro Area Ministers of Finance, ECB and EC) and ESM Management Board

What have we done so far?

- Five countries have received assistance
  - ESM has maximum lending capacity of €500 billion; including EFSF disbursements, combined lending capacity of nearly €700 bn
  - Comprehensive **reform packages** for Portugal, Greece, Ireland, and Cyprus
  - Programme to **restructure the financial sector** in Spain
  - Amount paid to five countries so far: over **€245 billion**
  - Support for the **banking sector** has been important
    - » €41.3 bn in indirect bank recapitalisation to Spain
    - » €37.3 bn to Greece (EFSF programme)
    - » €1.5 bn to Cyprus
  - Ireland, Spain, and Portugal have exited their programmes
  - New ESM programme for Greece (up to €86 bn)

Over €245 billion disbursed by EFSF and ESM to the five countries

- The **EFSF** has provided financial assistance to Ireland, Portugal and Greece

	Total programme amount (€ bn)	Amount financed by EFSF (€ bn)	Disbursed amount (€ bn)	Remaining amount (€ bn)	Outstanding amount (€ bn)	Average maturity (years)
Ireland	85.0	17.7	17.7	0.0	17.7	20.7
Portugal	78.0	26.0	26.0	0.0	26.0	20.8
Greece	164.4	141.8	141.8	0.0	130.9	31.1
Total	**327.4**	**185.5**	**185.5**	**0.0**	**174.6**	

Total amount disbursed by **EFSF and ESM:**
€245.6 billion

- The **ESM** has provided financial assistance to Spain, Cyprus and Greece

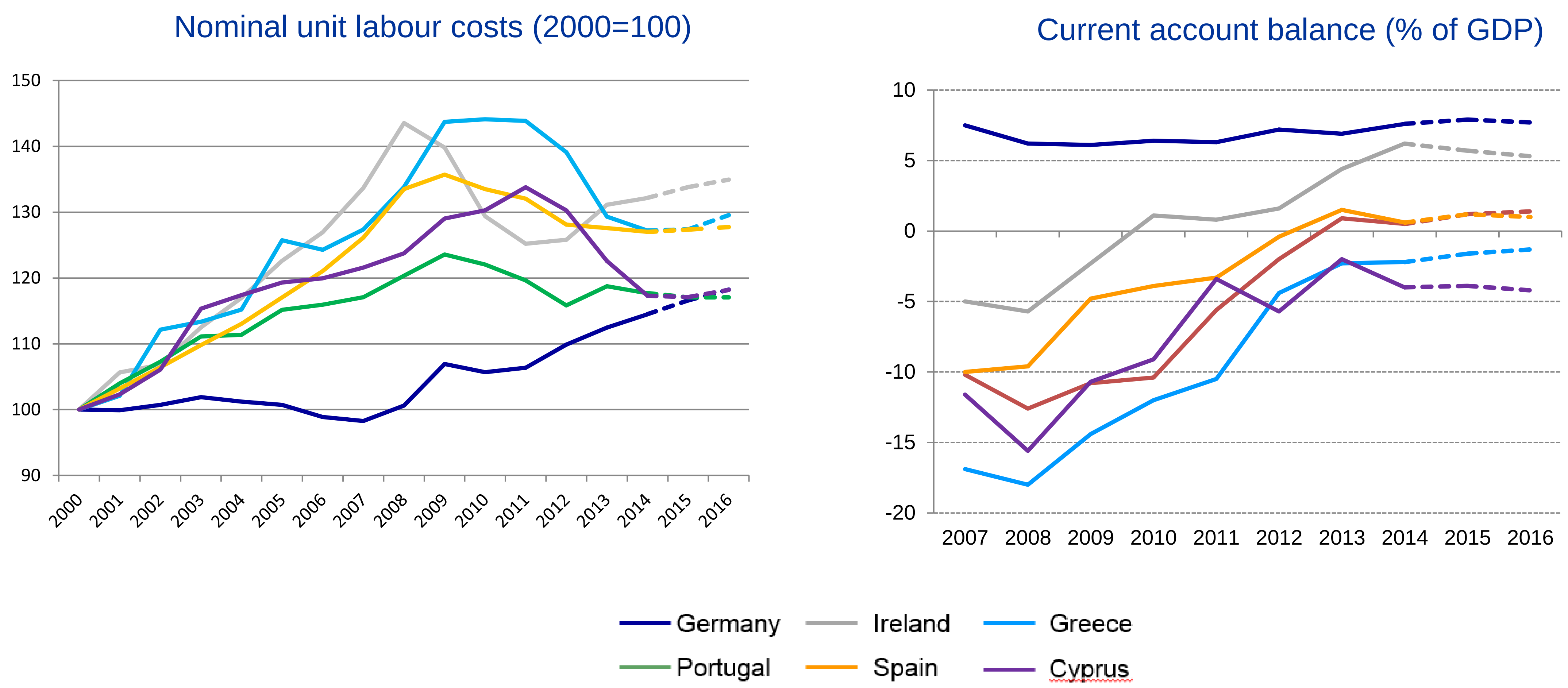
	Total programme amount (€ bn)	Amount financed by ESM (€ bn)	Disbursed amount (€ bn)	Remaining amount (€ bn)	Outstanding amount (€ bn)	Average maturity (years)
Spain	41.3	41.3	41.3	0.0	35.7	12.5
Cyprus	10.0	9.0	5.8	3.2	5.8	14.9
Greece	86.0	tbd	13.0	73.0	13.0	32.5
Total	**137.3**	**50.3**	**60.1**	**76.2**	**54.5**	

Total amount outstanding **EFSF and ESM loans:**
€229.1 billion

How has this helped the countries?

Structural reforms, internal devaluations are rapidly restoring competitiveness

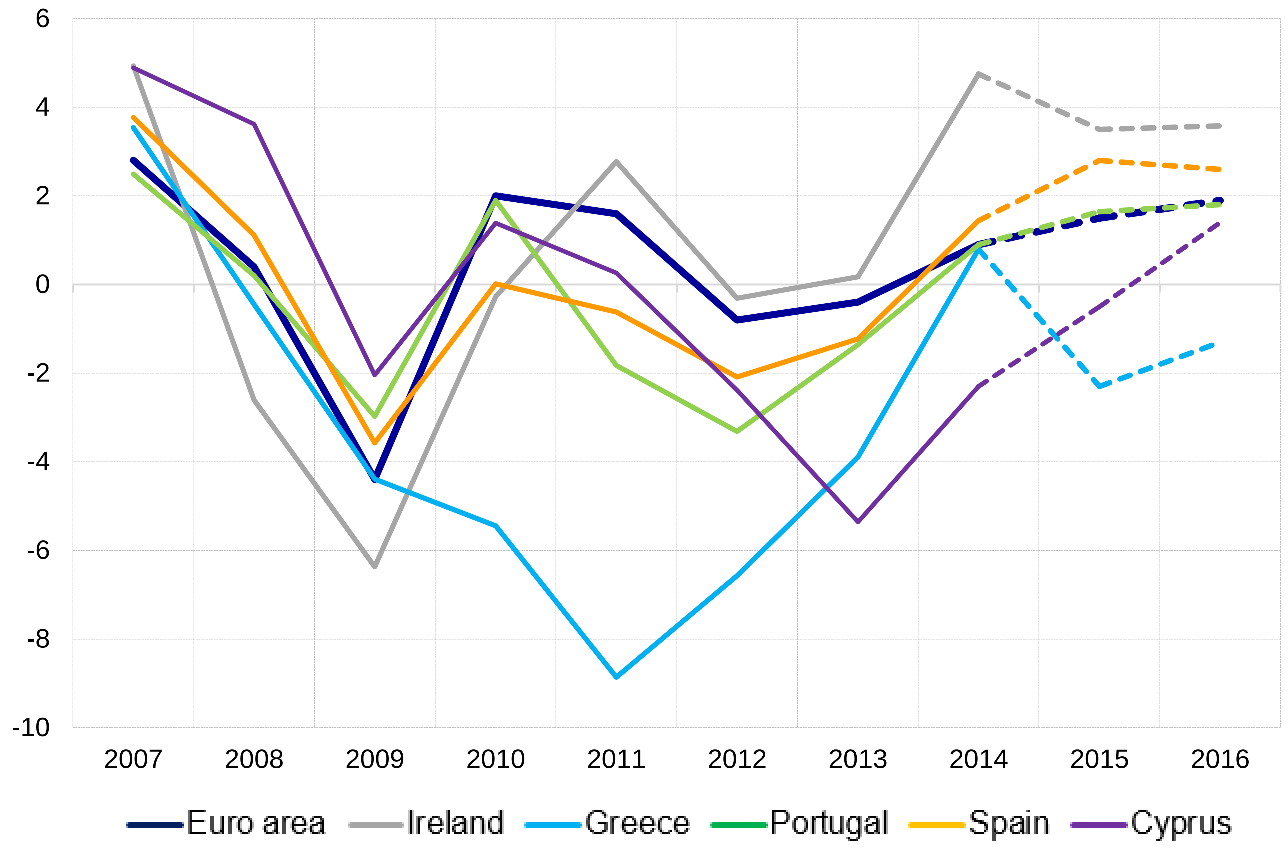
- Thanks to the convergence in competitiveness, costly external imbalances in the periphery have been corrected



Source: EC European Economic Forecast – Spring 2015

GDP growth is picking up in all programme countries

GDP growth, year/year (%)

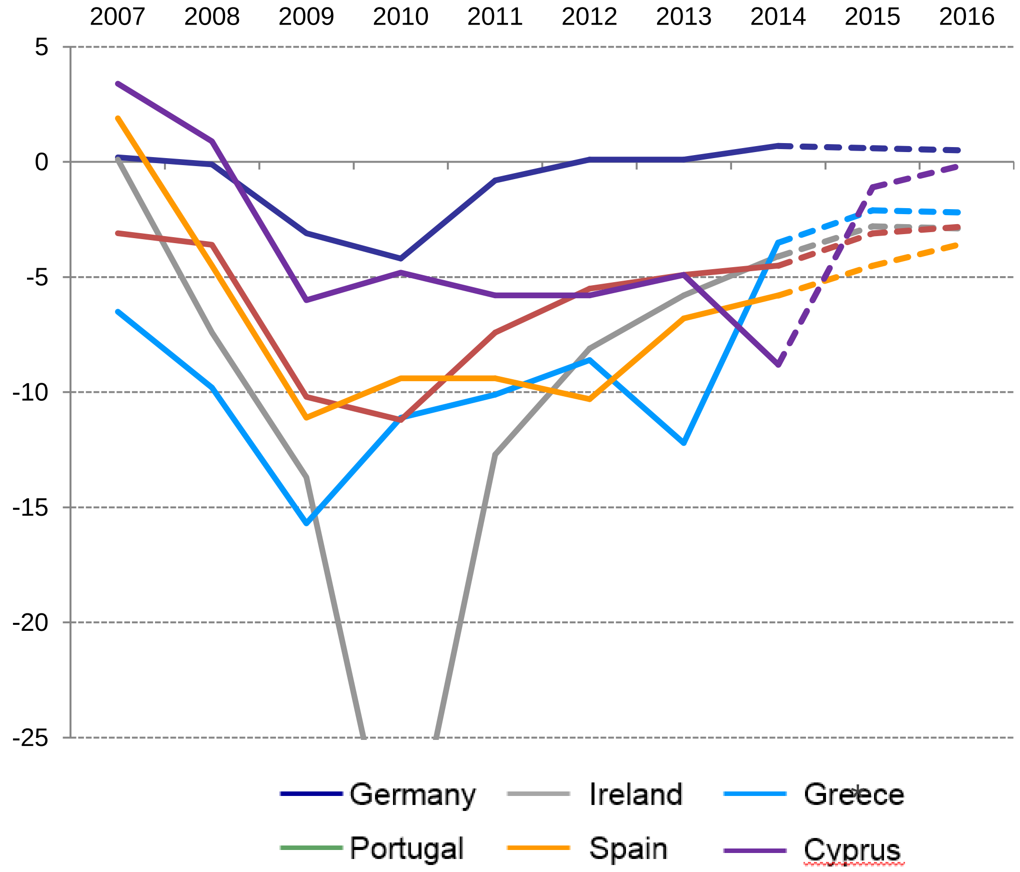


- **Ireland** is one of the fastest growing economies in the euro area (1st EFSF programme)
- **Spain** and **Portugal** are growing above euro area average
- **Cyprus** is on a good growth path (still under ESM programme)
- **Greece** was on the right track in 2014

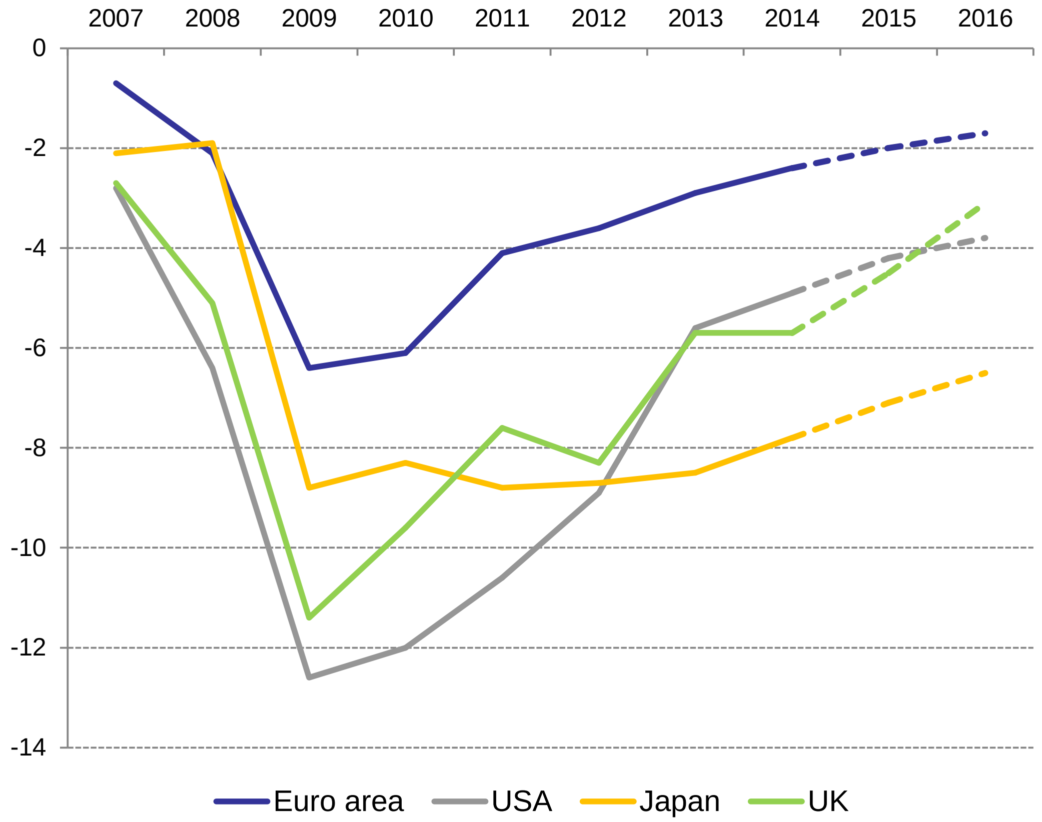
Source: EC European Economic Forecast – Spring 2015
(2015-16 figures for Greece based on EC and ECB projections)

The budgets of the countries are improving

Fiscal balance in programme countries (% of GDP)



Selected comparative fiscal balances (% of GDP)



Source: European Commission, Economic Forecast – Spring 2015

* Actual figure for Ireland in 2010: -32.4%

The programme countries have become reform champions…

- **Greece, Ireland, Portugal and Spain** are in top five of 34 **OECD countries** with regard to implementation of **structural reforms.**

Ranking in OECD report
1. **Greece**
2. **Ireland**
3. Estonia
4. **Portugal**
5. **Spain**

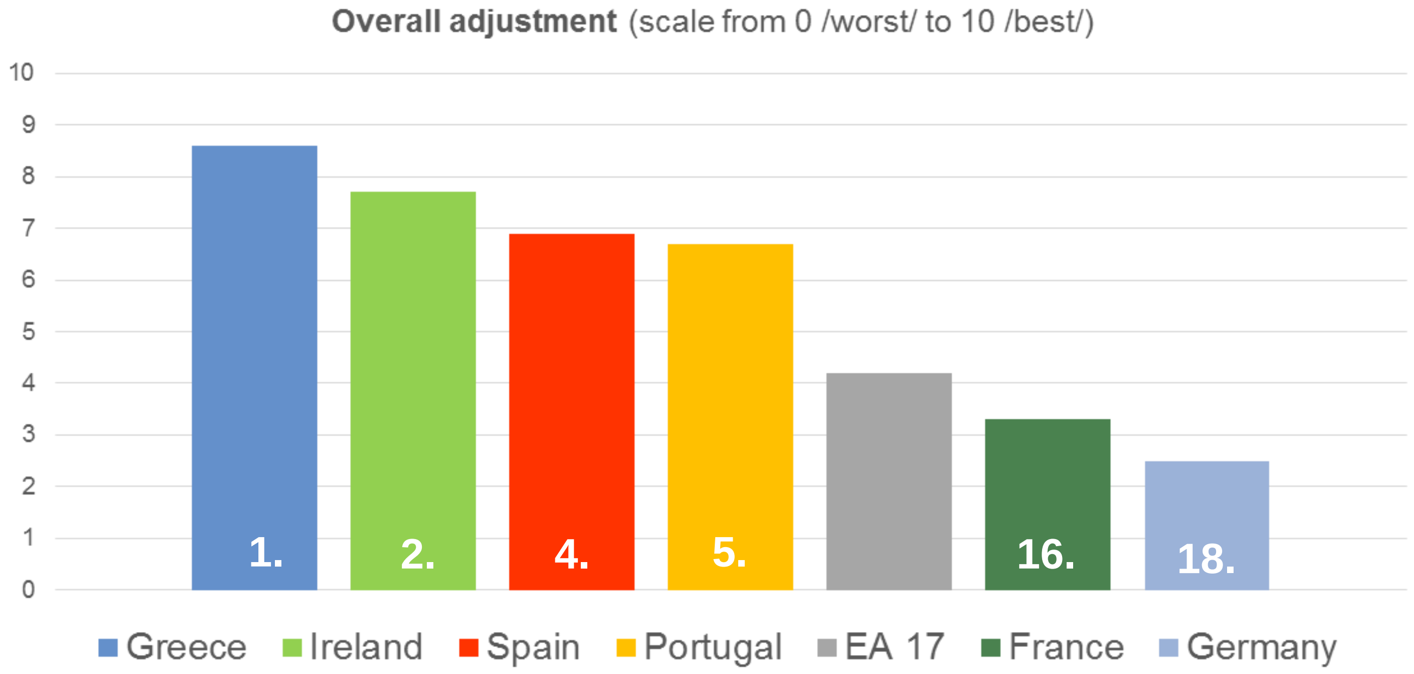
"Euro area countries under financial assistance programmes are among the OECD countries whose responsiveness [to the OECD's structural reform recommendations] *was highest and also where it most increased compared with previous period."*

- Going for Growth (OECD Report)

Source: OECD report *Going for Growth* for 2015
Ranking takes into account responsiveness to OECD recommendations on structural reforms in key policy areas

… and score high across rankings

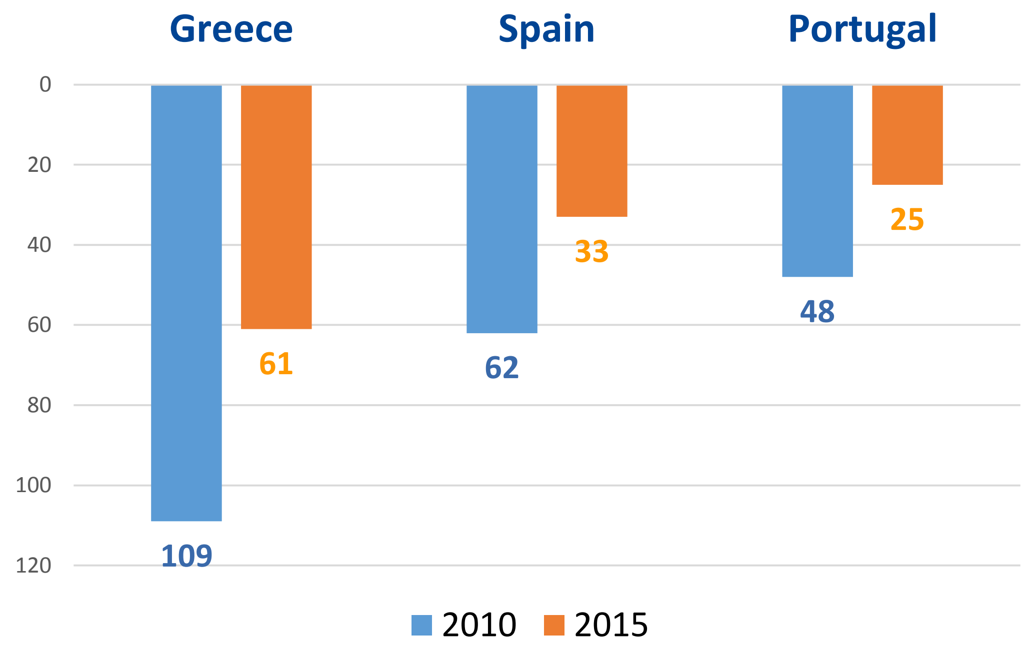
- **Lisbon Council: Greece, Ireland, Spain and Portugal** ranked highest in overall measure of 4 key medium-term adjustment criteria:
  - Rise in exports
  - Reduction of fiscal deficit
  - Changes in unit labour costs
  - Progress in structural reforms



Source: "Adjustment Progress Indicator" in *2014 Euro Plus Monitor* published by the Lisbon Council
The ranking comprised 17 euro area countries + UK, Poland and Sweden

Reforms include improved business regulations

- Greece, Spain and Portugal have recorded significant progress in the **World Bank's *Doing Business*** ranking since 2010
- The ranking measures the ease of starting and operating a local business



Source: the World Bank, *Doing Business* ranking, 2010 and 2015

Why are EFSF/ESM so attractive?

The EFSF/ESM lending rates are attractive to countries…

Low funding costs via bills and bonds deliver low rates for EFSF and ESM loans

ESM cost of funding*	0.955%

ESM lending rates	
Cyprus	1.254%
Spain	0.943%

EFSF cost of funding*	1.602%

EFSF lending rates	
Ireland	2.269%
Portugal	2.104%
Greece	1.371%

* Refers to pool funded loans, data as of 30/04/2015

… and so are the long loan repayment periods

Repayment of loan principal by beneficiary countries

Ireland	2029 - 2042
Portugal	2025 - 2040
Greece	2023 - 2059
Spain	2025 - 2027
Cyprus	2025 - 2030

Loans are a form of euro area solidarity

Savings via EFSF/ESM financing vs theoretical market cost (for 2014)

	In € billion	As percentage of GDP	As percentage of total primary expenditures
Cyprus	0.26	1.5	4.3
Greece	7.87	4.4	10.86
Ireland	0.09	0.05	0.15
Spain	0.82	0.08	0.21
Portugal	0.49	0.28	0.69

Calculated using the average sovereign market spread of each country matching the EFSF/ESM maturity profile. This is compared with the equivalent EFSF/ESM funding cost.

"[€8 bn in savings every year], means every Greek household saves €3,000 [annually]"

Former Minister of Finance Greece Gikas Hardouvelis

Evolution of the lending programmes: terms have improved for the beneficiaries (maturity and rates)

		European Official Support					International Monetary Fund Support				
		Vehicle	Program Duration	Size	Loan Maturity	Spread over reference rate[1]	Program Type	Program duration	Size	Loan Maturity	Spread over 3-month SDR
Greece	01/05/2010	GLF	3 years	80 bill	5 years (+3 grace period)	300-400 bps	SBA*	3 years	30 bill	5 years	200-300 bps
	June-2011	GLF			extended to 10 years	reduced to 200-300 bps					
	March-2012	GLF			extended to 15 years (+10 grace period)	reduced to 150 bps					
	March-2012	EFSF	3.5 years	144.7 bill	15 years (+10 grace period)		EFF	4.5 years	28 bill	6 years	200-300 bps
	December-2012	EFSF			extended to 30 years	***					
	December-2012	GLF			extended to 30 years	reduced to 50 bps					
Ireland	December-2010	EFSM	3 years	22.5 bill	7.5 years	300 bps					
	December-2010	EFSF	3 years	17.7 bill	7.5 years	300 bps	EFF	3 years	22.5 bill	7 years	200-300 bps
	July-2011	EFSF/EFSM			extended to 15 years	reduced to 100 bps					
	June-2013	EFSF/EFSM			extended to 22 years						
Portugal	May-2011	EFSM	3 year	26 bill	7.5 years	215 bps					
	May-2011	EFSF	3 year	26 bill	7.5 years	250 bps	EFF	3 years	26 bill	7 years	200-300 bps
	July-2011	EFSF/EFSM			extended to 15 years	reduced to 100 bps					
	June-2013	EFSF/EFSM			extended to 22 years						
Spain	July-2012	ESM	2 years	100 bill**	12 years	below 100 bps					
Cyprus	June-2013	ESM	3 years	9 bill	15.5 years	below 100 bps	EFF	3 years	1 bill	7 years	200-300 bps

Sources: International Monetary Fund, European Commission, European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM). EFSM stands for the European Financial Stability Mechanism. * The SBA program was replaced by the susequent EFF. [1] For the EFSM loans the reference rate is the EU funding costs, for the EFSF the EFSF's cost of fuding and for the GLF the 6 month Euribor. ** Only 40 billions were actually disbursed. *** On December 2021, the EFSF waived Greece the payment of the guarantee commitment fee and deferred interest payments for 10 years.

What happened in Greece?

Greece was successfully growing out of the crisis in 2014

- Structural reforms
  - Greece topped the OECD ranking on structural reforms, gained 48 positions in the overall ranking in the World Bank's *Ease of Doing Business* index
  - Greece was well positioned for future growth if it continued the reforms
    - » Unit labour costs improvement (-1.8%)
    - » Fiscal surplus of 0.8%
    - » Exports rising 1.8% and imports declining 5.3%
- Macroeconomics
  - GDP expanded by 1% in 2014, and forecasted to reach 2.9% in 2015 and 3.7% in 2016
  - Unemployment decreased from the peak (27.5%) in 2013, to 26.8% in 2014
- Capital Markets
  - Greece successfully issued a 5-year bond in April 2014 (rate of 4.95%) and 3-year bond in July 2015 (3.5%)
- Greece's intention was to wrap up the program and potentially go for a precautionary credit line.
  - Market reaction was mixed to this intention (bond yields increased)
  - There was no agreement for closure of EFSF programme review
- Therefore, Greece requested a technical extension of the programme in December 2014

Change of track had large consequences in 2015

- Two elections and one referendum
- Reforms were frozen or turned back
  - Macroeconomic impact:
    - GDP forecast level reduced from 2.9% to 0.5% in 2015
    - Unemployment forecast increased (0.6% in 2015, 1.2% in 2016)
- *April:* private sector deposits in Greek banks fell by €30.6bn (19%). Lowest level in more than a decade.
- *June:* Greece closed banks and imposed capital controls
- *End June:* 2nd EFSF bailout program ends. Greece misses €1.6bn payment to IMF. EFSF declared default.
  - Capital Markets: Bonds yield increase to a peak of 19.4% (10y) and 35.86% (5y)
- July: Many crisis meetings, euro area leaders agree on 3rd bailout package (12 July). ESM BoG decided to grant, in principle, support to Greece in the form of a loan (17 July)

New ESM programme for Greece should put the country back on track

- ESM Board of Governors approved **new financial assistance programme for Greece** on 19 August 2015
- ESM will provide **up to €86 billion** in loans to Greece over 3 years
- Loans will be used for:
  - debt service
  - bank recapitalisation
  - arrears clearance
  - budget financing
- Maximum weighted average maturity of loans: **32.5 years**
- IMF expected to contribute to programme after European creditors adopt debt relief measures

The three financial assistance programmes for Greece

- The new ESM programme is the third package of financial assistance for Greece

1st programme

(2010-2011)

- Greek Loan Facility (bilateral loans): €52.9 bn
- IMF: €20.1 bn
- **Total: €73 bn**

2nd programme

(2012-2015)

- EFSF: €141.8 bn
- IMF: €11.7 bn
- **Total: €153.5 bn**

3rd programme

(2015-2018)

- ESM: up to €86 bn (committed)
- IMF: TBD

- ESM is the largest creditor of Greece. Currently, 45% of all Greek public debt. If third programme is fully disbursed, ESM will hold 60% of all Greek public debt.

Note: For the first two programmes, amounts disbursed are shown. For IMF loans (disbursed as SDR), the corresponding figure in euros is based on exchange rate at time of disbursement

Greece already received a form of debt relief

- Greece received a form of relief already:
  - Maturities ESM are 32.5 years
  - Interest rate ESM 1.371% vs 3.6% of IMF
  - Present value of ESM loans is substantially lower than headline value (€86 bn)
  - This difference can be regarded as debt relief of around €40 bn
- Politically very difficult, but if needed additional debt relief measures for Greece are possible:
  - Lengthening loan maturities
  - Longer interest deferral
  - Resuming transfer of ANFA and SMP profits to Greece
- Debt relief can make a difference, but the key to success for Greece is consistent implementation of reforms – to create an economic environment that stimulates sustained growth

What is next for Greece?

- Need to successfully implement the new programme (MoU, conditions, etc)
- ECB/SSM to conduct comprehensive assessment of Greek banks
- Possible additional measures such as longer grace and payment periods (no nominal haircuts on debt)
- Other elements:
  - Commission to support growth and job creation over the next 3-5 years mobilising up to €35 bn under various programmes
  - Fund investment and economic activity including SMEs
  - Investment Plan for Europe will also provide funding opportunities for Greece

What makes the ESM unique?

Modern, efficient and effective institution

- The aim of the ESM was to become a modern, efficient and cost-effective institution
- ESM is a very lean institution: 144 staff members
  - Recruitment is not restricted to EU citizens (China, Zimbabwe, Kazakhstan, United States, etc)
  - Recruitment from global top universities: Harvard, Oxford, Wharton, RSM, etc
  - Mix of public (IMF, ECB, Wold Bank, EIB, Ministries of Finance) and private sector (Goldman Sachs, Deutsche Bank, ING, McKinsey) employees
- Many non-core functions are outsourced to the private sector
  - Back office: Citigroup, Trading platform: Murex, Technology: Post.lu, etc
- Modern and cost-efficient offices (eg office space)
- No balance sheet responsibility to former ESM staff, fully funded pension scheme
- Staff turnover of 11%, all staff start on short-term contracts, performance based renewal

Benefits of EFSF/ESM

- Keeping the euro area together
- Promote reforms and adjustment
- Support debt sustainability
- Lender of last resort for sovereigns (thus making life easier for the ECB)
- Exemplary modern institution

What is next for the euro area?

What’s next for the euro area?

- Further deepening of the EMU: proposal presented in Five Presidents report (June 2015) and preparation for the European Council in December 2015

Stage 1 (by mid 2017)

- Progress in Economic and Financial Unions, i.e. Banking Union and Capital Markets Union
- Strengthening European Semester (more Eurogroup-centric) , introduce advisory European Fiscal Board and system of competitiveness authorities
- More parliamentary involvement in European Semester (inter-parliamentary cooperation, European Parliament is to “organize itself” for its role in euro area policy making).
- EU institutions’ coordination to be tightened through a non-binding inter-institutional agreement;
- Gradual reform of euro area external representation

Stage 2 (after 2017)

- develop fiscal stabilization scheme against big shocks requiring further convergence, integration and policy coordination
- more fiscal transparency needed and a review of Six-Pack and Two-Pack
- Permanent full-time PEG with a higher profile in external representation
- ESM to be brought under EU treaty framework

Stage 3 (by 2025)

- A broad objective of treasury taking decisions on fiscal issues
- In long-term, Fiscal Union needs collective decision-making: paper foresees a euro area treasury for this

Annex

5. Raising firewalls against the crisis (EFSF and ESM)

Mission: to safeguard financial stability in Europe by providing financial assistance to euro area Member States

Instruments

- ***Loans***
- ***Primary market purchases***
- ***Secondary market purchases***
- ***Precautionary programme***
- ***Bank recapitalisations through loans to governments***
- ***Direct bank recapitalisation*** (European Stability Mechanism esm)

All assistance is linked to appropriate conditionality

EFSF and ESM finance their activity by issuing bonds and other debt instruments

Funding Strategy

Funding strategy

Short term funding

- Regular bill programme (ESM only)
- Unsecured money market

Long term funding

- Highly liquid benchmark bonds
  - Up to 30 year
  - Taps possible
  - Via syndications, auctions
  - Private placements
  - Non euro currencies allowed

Cashless transactions

- Issue & Repurchase Process

Fund pool

- Funds are not attributed to one country but pooled
- One lending rate for all countries

Diversified Funding Strategy

A comprehensive response to the euro crisis

1) Establish a crisis mechanism

- EFSF and ESM have disbursed to Ireland, Portugal, Greece, Spain and Cyprus
- EFSF/ESM loans support adjustment and debt sustainability

2) Reduce vulnerabilities, implement reforms

- Macroeconomic imbalances are disappearing
- Strong growth in programme countries

Covered in the main presentation

3) Strengthen governance of euro area

- More comprehensive and stricter rules for policy coordination and surveillance
- Rules need to be credibly implemented

4) Create a stronger European banking system

- European banks have doubled their capital since 2008 and now have a Core Tier 1 capital ratio of 9% or more
- Banking Union is being established

5) An active monetary policy

- The ECB's unconventional measures have ensured sufficient liquidity and removed the threat of deflation

Strengthen governance of euro area

Improved economic policy coordination

- Euro governments adopted **more comprehensive and binding rules** for national economic policies
  - **Stability and Growth Pact** has stricter rules on deficit and debt
  - **Less room for political interference** by national governments
  - **Balanced budget and debt rules** now also in national legal systems
  - **European Semester**: yearly cycle of economic policy coordination
  - Annual **country-specific recommendations**
  - Stronger emphasis on **avoiding macroeconomic imbalances**
  - **Eurostat** authorised to verify national data

How can goverance be strengthened further?

- Additional steps in euro area integration likely
- **Proposals under discussion:**
  - a euro area finance minister
  - a “fiscal capacity” for the euro area
  - joint decision-making for structural reforms
  - more democratic accountability and legitimacy
- Implementation legally and politically difficult and time-consuming

Create a stronger European banking system

A stronger banking system

- **Three new European supervisory authorities: EBA, EIOPA and ESMA**
- New **ESRB** monitors macro-prudential risks
- **Financial market reforms**
  - “Basel III” (CRDIV/CRR) is being progressively implemented
  - Huge capital increase for banks – Core Tier 1 capital ratios are now 9% or more
  - EU banks added €560 bn to their capital since 2008
- **Banking Union** started in November 2014
  - **Single Supervisory Mechanism** (SSM) operational since 4 November 2014
  - **Bank Recovery and Resolution Directive** (BRRD) will create a uniform framework for bank recovery at national level with **bail-in** as a key instrument
  - **Single Resolution Mechanism** (SRM) with **Single Resolution Fund** (SRF)
  - **ESM Direct Recapitalisation Instrument** available

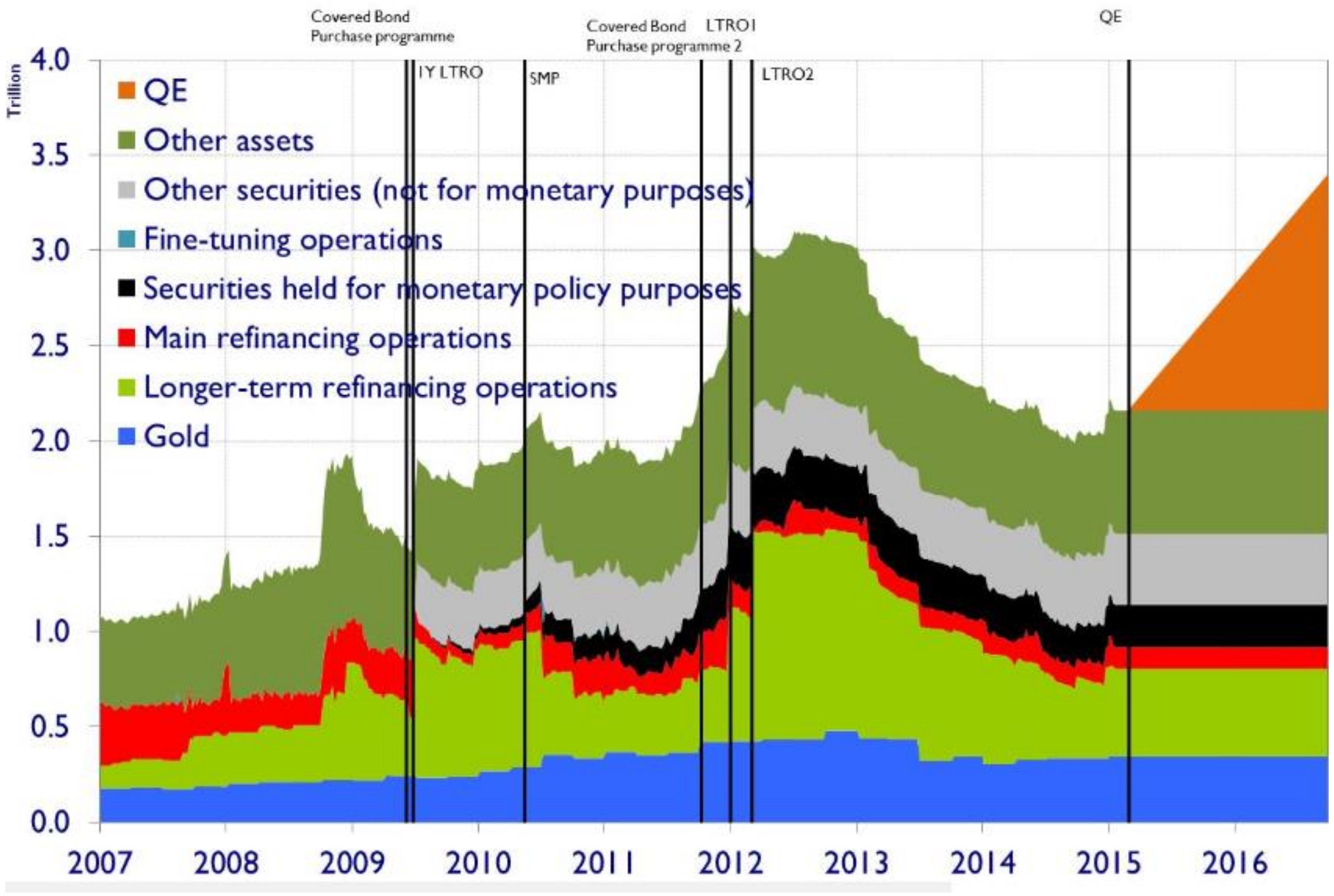
An active monetary policy

Monetary policy

- **SMP**: from 2010 to 2012, ECB purchased euro area sovereign bonds (over €200 billion) in secondary markets
- **LTRO** gave banks unlimited liquidity: in December 2011 and March 2012, around **€1 trillion** allotted in 3-year loans
- **OMT** announcement in September 2012 calmed the markets
- **New package** in June 2014
  - Targeted LTRO (at least €400 billion available lending capacity) designed to stimulate lending to small- and medium-sized companies
  - Negative deposit rate
- Programme for buying ABS and covered bonds announced in September 2014
- **Quantitative Easing** programme announced in January 2015
  - Asset purchases expanded to include euro area government bonds
  - Combined monthly purchases of €60 billion from March 2015 to September 2016

QE asset purchases by the ECB started in March 2015

The ECB's balance sheet is to reach €3.4 trillion in Sept. 2016



European Stability Mechanism

III. Restoring growth in the euro area

Focus on growth

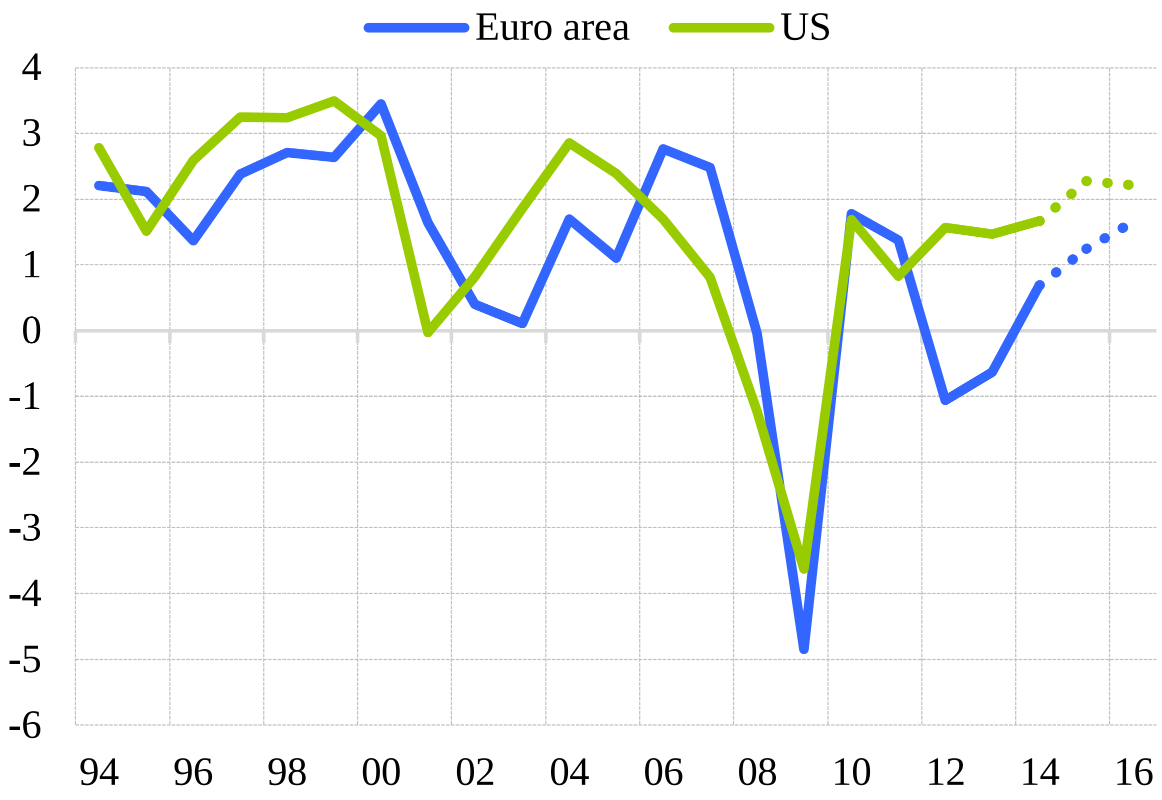
- **Economic recovery** in euro area is boosted by **external factors** and **policy measures**
  - fiscal headwinds disappear
  - lower energy prices boost consumption and investment
  - weakening of euro exchange rate supports net exports
- **Structural reforms** are crucial for raising potential growth and they are a precondition for the effectiveness of monetary and fiscal policy
  - Adjustment programmes include long lists of structural reforms
  - European Commission and Council adopt recommendations for each Member State on ways to stimulate growth and create jobs
- Europe has a lot to offer for **education** and **training**

Focus on growth: more can be done

- **Juncker Plan**: creation of European Fund for Strategic Investments (EFSI)
  - A guarantee of **€16 billion** will be created under the EU budget; the EIB will commit €5 billion
  - The Fund has the potential to yield **€315 billion of financing** over three years, thanks to estimated **multiplier effect** of 1:15
  - EFSI will support strategic investments in **infrastructure, education and research**, as well as support risk finance for **SMEs and mid-cap companies**
- **Further measures** are needed
  - Single Market should be completed to boost growth
  - Proposed Capital Markets Union would reduce reliance on bank funding in Europe
  - Private debt deleveraging should be promoted

GDP per capita growth comparison

GDP/capita growth since 1994 has been very similar in US and EU



Average GDP growth per capita, 1999-2008

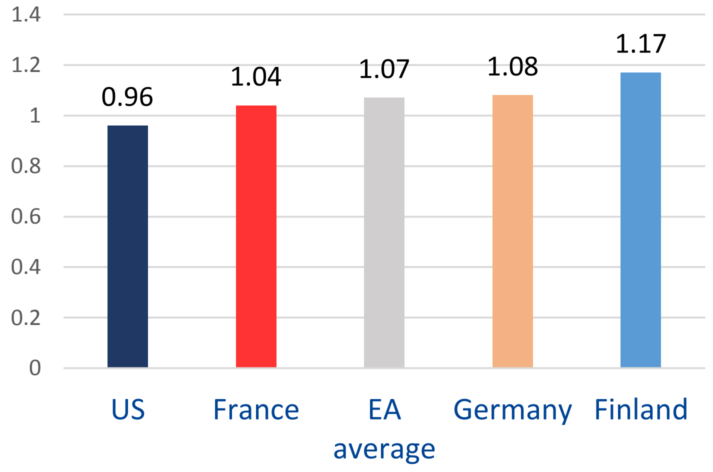
euro area	1.6
US	1.6

Source: Spring 2015 European Commission forecast

Economic well-being shows more than GDP/capita

- A study was recently conducted by Boston Consulting Group on **economic well-being** around the world
- The study defined well-being through three elements that comprise 10 dimensions**:**
  - **Economics**: income, economic stability, employment
  - **Investments**: health, education, infrastructure
  - **Sustainability**: income equality, civil society, governance and environment
- The study developed two coefficients providing relative indicators of how well a country has converted its (i) wealth and (ii) growth into the well-being of its population

Wealth-to-well-being coefficient in selected countries in 2015



Source: Boston Consulting Group, *2015 Sustainable Economic Development Assessment*

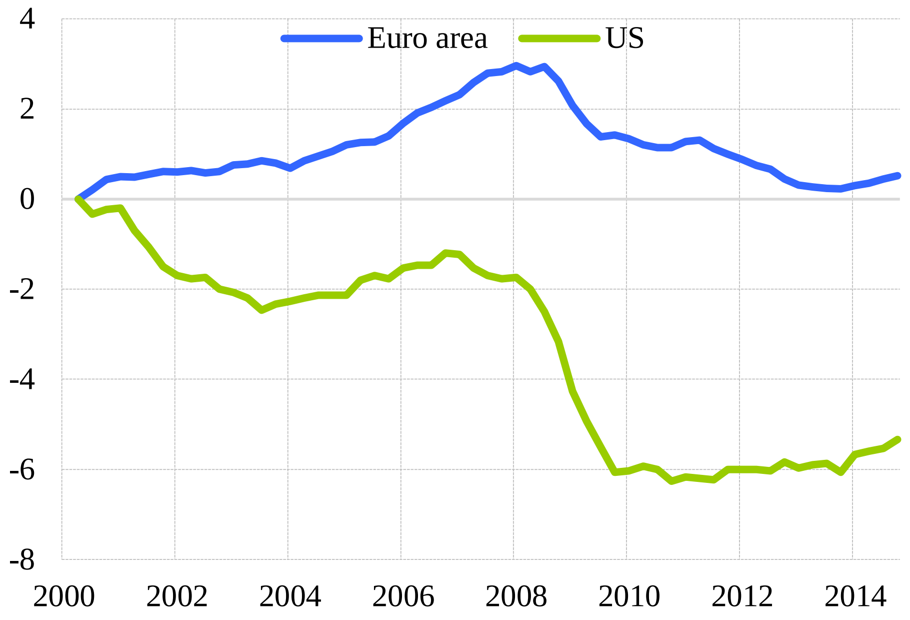
How the US and Germany have translated growth into well-being

- From 2006 - 2013, the US and Germany both recorded an average GDP growth rate of 1.1%
- Germany's ability to convert growth into economic well-being was equivalent to an economy growing at an average rate of 6.2%
- In the case of the US, it was equivalent to an average growth rate of only 0.5%

Labour markets

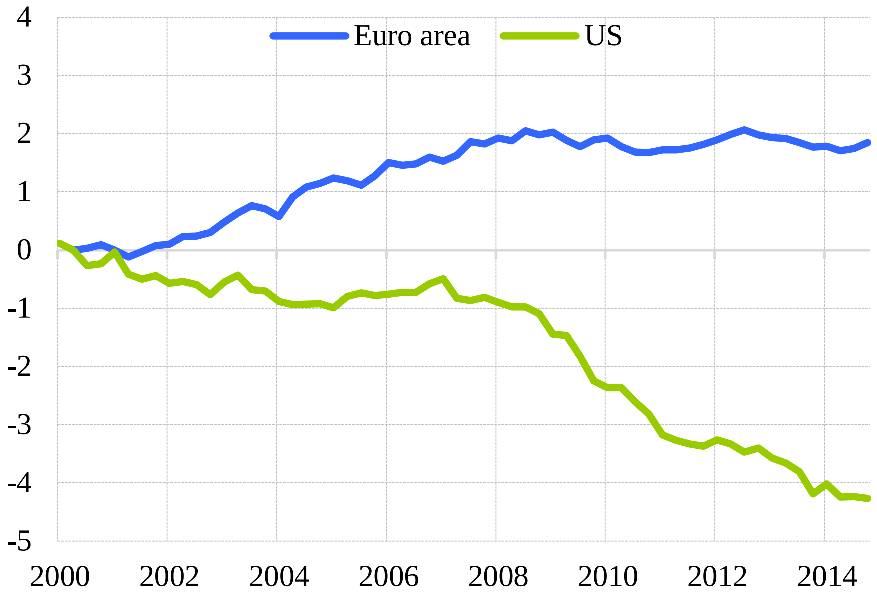
- Since 2000, employment rate has increased in euro area but fallen by around 6 p.p. in the US
- Participation rate in euro area stabilised after rise until 2009; in US continues to decline

Employment rate change since 2000 (%)



Age group: 15+ for euro area, 16+ for US
Latest observations: Q4 2014
Source: Eurostat, BLS and ESM calculations

Participation rate change since 2000 (%)



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