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THE ROLE OF BAILOUT MECHANISMS IN THE EUROPEAN MONETARY UNION

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Abstract: *The material presents the initial measures aiming to prevent spreading of financial contagion in the European Monetary Union and more specifically urgently initiated temporary instruments for financial assistance in order to overcome the liquidity problems in the toughest initial period of the sovereign debt crisis. Later on a permanent bailout mechanism European Stability Mechanism was constructed and its mandate is analyzed. The author's idea is that the bailout mechanisms have a short-term potential. In longer perspective their effect is more likely to be unfavorable for the development of the monetary union, because bailout mechanisms tend to increase moral hazard and create unsound dependency of the ineffective economies on donor – countries. In fact the bailout mechanisms contribute for strengthening and stabilizing the economic differentiation between member states in the European Monetary Union.*

Keywords: *European Monetary Union, bailout mechanism, European Stability Mechanism*

1. Introduction

When the European monetary union was created, the integration processes in Europe were defined as irreversible. Monetary integration is considered the highest form of integration among countries. Accordingly the strategic project for the euro zone was meant to offer the member countries financial and economic stability. The intention for the euro was to be a stable and protected monetary unit, guaranteed by the economic potential of the member countries. This is the reason why the creators of this project have not foreseen any bailout mechanisms. In fact one of the key missing elements in the European project for creating a single monetary unit is a system for dealing with financial institutions in trouble. In the course of a long period the membership in the monetary union has been considered to guarantee economic stability and protection from serious financial and economic problems. This can be defined as an expression of the so-called moral hazard and the low interest rates

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for financing of all public debts in the euro area in the course of a decade after its creation - as a concrete result of the realization of this risk. The easy and low-cost access to the financial markets for mobilizing public resources has definitely deprived of stimulus and motivation for budget discipline and necessary structural reforms, some countries in the monetary union.

2. Temporary Bailout Mechanisms – Functions and Effects

In the course of more than two years after the contemporary sovereign debt crisis in the euro zone began, the measures of the authorized institutions were brought to constructing emergency rescue packages and mechanisms, as a result of which the big sovereign debts of problem countries became even bigger. The first of urgently initiated instruments for financial assistance after the debt problems of Greece began, was **EFSF /European Financial Stability Facility/**. It came into force in May 2010. The facility was created by the 27 member states of the European Union with a mandate to provide financial assistance so that no spreading of financial contagion in the monetary union is allowed. A country could apply for financial assistance from EFSF if only its access to the capital markets is already at unacceptably unfavorable interest rate conditions. Besides the problem country had to negotiate a macroeconomic adjustment program with the financial ministers of the countries in the euro zone.

EFSF was meant as a temporary measure – an emergency rescue mechanism in the form of SPV /Special Purpose Vehicle/, managed by the European Investment Bank /the bank of the European Union/. SPV is a product of financial engineering, which is well known on the financial markets and one of the goals herewith is to protect the investors in the debt securities issued by the EFSF.

The created temporary facility was meant to raise money by issuing bonds and other debt instruments on the capital and money markets and also to buy sovereign debt on the primary and secondary markets under certain conditions. The facility has been functioning on the basis of definite engagements by member states in the euro zone for providing credit guarantees amounting to 780 billion EUR and effective lending capacity up to 440 billion EUR. The guarantees are provided in proportion to the membership quota in the share capital of the European Central Bank. This rule makes again Germany and France the two countries – biggest financial contributors for the facility.

EFSF has been activated several times so that the negotiated financial assistance for Ireland, Portugal and Greece can be provided. The participation of the temporary rescue facility in the officially negotiated financial assistance was made possible as a result of issuing long- and short-term debt instruments on the capital and money markets. The long-term debt /3-, 5- and 10-year bonds/ amounted to 19 billion EUR and the short-term debt /3- and 6-months/ - about 3,5 billion EUR. This is how the established facility covered its part in the financial assistance for Ireland, Portugal and the second rescue financial package for Greece.

Another rescue financial package from EFSF was negotiated in June 2012 for the Spanish bank system, amounting up to 100 billion EUR, allocated in several tranches. In this case the authorized institutions in the monetary union, respectively their decisions not just followed the reaction of the financial markets, but these decisions were in very short time corrected as a response to the market reaction. The initial plan for financially assisting the Spanish bank system included simply providing financial resources for the Spanish government, which on its part should channel them to recapitalize national banks in trouble. An immediate reaction of the financial markets followed and more precisely the market price for financing of Spanish sovereign debt increased sharply. The reason for the market reaction was obvious – if done this way, the measure directly piles up more sovereign debt. Spain immediately opposed to this way for recapitalizing of the Spanish banks and the decision was corrected. The new idea was that the functioning temporary facility should directly recapitalize the troubled Spanish banks, breaking formally this way the connection between bank debt and sovereign debt. In fact this is still a very important goal for financially assisting problem banks from the European bailout mechanisms. This goal can be defined as ***directly assisting banks with problems in the monetary union so that recapitalizing in the form of international financial assistance does not lead to more sovereign debt.*** Mainly because of Germany's objections, in this first case with Spain the financial resources from the rescue package were initially disbursed to a special Spanish bank restructuring and recapitalization fund /established in 2009/, acting as an agent of the Spanish government. On Germany's insistence, the European Council decided that no direct assistance to banks will be provided until a European banking supervisor becomes fully functioning. The idea is that the loans disbursed to the Bank restructuring and recapitalization fund constitute government debt and the Spanish government is responsible for the repayment of the debt. Formally the loans from the bailout mechanism increase the government debt.

When the permanent bailout mechanism in the monetary union was established, the program for financial assistance for the Spanish bank system was transferred to the European Stability Mechanism.

In the course of the functioning, several changes in the EFSF came into effect and more precisely the total value of the government guarantees was increased, respectively the scope of the guarantees was enlarged so that they cover not only the loan principle but the interest rate and the managing costs of debt instruments' issue. In fact the member countries in this mechanism agreed to provide credit guarantees with no upper limit.

The credit rating of the facility as well as its debt issues depend directly on the guarantees' quality. In January 2012 Standard and Poor's lowered the credit rating of EFSF as well as the issue ratings on its long-term debt securities by one notch to AA+ and the reason was connected to the worsening economic conditions in the countries - guarantors.

The temporary bailout mechanism remains active in parallel to the established permanent mechanism and will be dissolved when repaid in full.

A new program for emergency financing was created by the EU member states in 2010 – **EFSM/European Financial Stabilization Mechanism**/. This is a lending arrangement and the European Commission manages the borrowing on the capital markets on behalf of the European Union. The Commission is considered as guarantor and the budget of the European Union as collateral. This rescue mechanism is authorized to raise cash on the capital markets up to 60 billion EUR and the financial resources are then transferred to countries in proven need in the form of a loan or a credit line. This mechanism provided a part of the bailout financial assistance for Ireland and Portugal amounting to 48,5 billion EUR.

EFSM has the highest credit rating given by the three main credit agencies – Standard and Poor's, Moody's and Fitch.

Both temporary facilities for emergency financing – EFSF and EFSM are in fact parts of a wider safety net for European financial assistance, constructed after the contemporary sovereign debt crisis in the euro zone began. Some specific features of the temporary bailout mechanisms were due to the lack of a legal basis for such measures in the European Union treaties in the initial period of the crisis. The framework for reinforced economic surveillance and financial assistance established after the crisis processes in the monetary union began, also includes the permanent bailout mechanism /since October 2012/ and funding from the International Monetary Fund, as well as bilateral assistance.

The functioning of the urgently constructed financial instruments for international bailout in the contemporary crisis processes in the euro area could not contain spreading of financial contagion. The international investors continued to shun the debt securities of problem countries from the so-called periphery of the euro zone and respectively the market spreads remained very high compared to the German sovereign bonds for quite a long period.

3. Permanent Bailout Mechanism – Characteristics and Implications

Having in mind the unsatisfactory effects from the functioning of both temporary bailout mechanisms, a permanent mechanism for financial assistance was constructed with different characteristics. The intended measure came into contradiction with the Treaty on the Functioning of the European Union and that is why the European Council proposed an amendment and the European Parliament approved a treaty change and in this way the establishment of a permanent bailout mechanism was allowed. **ESM /European Stability Mechanism/** came into force in October 2012 after a separate international treaty among the euro area states was signed. Both the amendment of the Treaty on the Functioning of the European Union and the separate treaty between the euro zone states required ratification and the difficulties in the process revealed once again existing problems between the countries involved.

The main characteristics of this mechanism are very important since its functioning concerns fundamental principles not only in the monetary union but in the European Union as a whole. By establishing a permanent bailout mechanism, medium- and long-term effects can be expected and evaluated.

The European Stability Mechanism is an intergovernmental financial institution established under international law. It is meant to replace both EFSF /a company established under Luxembourg law/ and EFSM. In fact these mechanisms will co-exist for some time. One of the main differences between the ESM and the temporary mechanisms is that the ESM has paid-in capital /80 billion EUR/ and callable capital /622 billion EUR/. This makes a total capital stock of approximately 702 billion EUR. Each member state's participation is based on its share of capital in the European Central Bank. ECB contribution key is based on the respective country's share in the population and GDP of the European Union as a whole. By using the same shareholder contribution key, Germany and France are again the biggest financial contributors in the newly created intergovernmental European institution. Germany's share in the ESM financing is more than 27 % and that of France – more than 20%. This percent determines also the share of Germany's and France's voting power in the Board of Governors and the Board of Directors. The Board of Governors includes the finance ministers of the euro zone countries as voting members and its responsibility can be defined as making fundamental decisions – in fact the highest – level decisions in the ESM. Non-voting observers may also participate and these are the President of the European Central Bank and the European Commissioner for Economic and Monetary Affairs. It is the Board of Governors' mandate to appoint the Managing Director. The first Managing Director of the ESM is from Germany. The Board of Directors consists of representatives from each member state /one director and one alternate director/ and is responsible for day–to–day management of the institution. Fundamental decisions in the ESM are taken unanimously while organizational and technical decisions require qualified majority of 80%. This rule gives Germany a blocking power for both types of decisions. A very important characteristic is that Germany's representatives in both boards can vote only with prior authorization from the Bundestag.

The principle for establishing the financial contribution and voting power in the permanent bailout mechanism and other official European institutions and measures too, works for the dominant German position – in the monetary union and the European Union as a whole. This is based on economic and political reason – Germany has the biggest economy and the most successful economic model in Europe. Besides Germany's part in the high-level global politics in no case can be neglected. *But this highlights one of the main problems in the euro zone and more specifically the fact that Germany usually expresses different opinions on the most important financial and economic problems – different from the countries – biggest debtors and eventually beneficiaries of financial assistance in the European monetary union. /The European Stability Mechanism /ESM/, www.bundesfinanzministerium.de/. In fact the established principle contributes to further stabilize the economic and political differentiation in Europe.*

Another important difference between the temporary rescue mechanisms and the ESM is that the permanent mechanism has the preferred creditor status. This means that the permanent mechanism's loans will be given senior class, which is lower /junior/ only compared to the loans of IMF. In fact the ESM will function in certain aspects in cooperation with the IMF.

The decision is that only countries that have signed and concluded the ratification process for the Fiscal Stability Treaty are eligible to apply for financing from the permanent bailout mechanism. There are four main financial assistance instruments of the ESM and they include: loans to an eligible country, purchase of bonds in primary and secondary debt markets, precautionary assistance in the form of a credit line and financial recapitalization of banks. The second form is meant to function by PMSF /Primary Market Support Facility/ and SMSF /Secondary Market Support Facility/. The precautionary financial assistance is meant to support sound macroeconomic and financial policies and respectively prevent crisis situations in the countries concerned. It is provided in the form of PCCL /Precautionary Conditioned Credit Line/ and also ECCL /Enhanced Conditions Credit Line/. Conditionality principle applies to all forms of financial assistance from the ESM.

There is an idea that the permanent bailout mechanism should contribute to cutting the link between bank and sovereign debt, respectively between private bank losses and sovereign debt crisis. The permanent bailout mechanism ESM was meant to directly recapitalize the banks in trouble – in this way the sovereign debts will not be extra burdened with the financial assistance for problem banks in the national economy. For the time being the valid form for financial recapitalizations of financial institutions from the ESM is that this financial assistance will be provided through loans to governments and in this way the government is the responsible counterparty for debt repayment. There is an Article 19 of the ESM Treaty that makes possible direct recapitalization of banks by unanimous vote in the Board of Governors of the permanent bailout mechanism.

The author's view is that the rules for the functioning of the ESM open a new channel to a common debt in the euro area. Banks in trouble can receive financial assistance from the permanent bailout mechanism, which means that bank debts of a euro zone country can turn into a common debt. Having in mind that each country's financial contribution is proportionate to its share in the ECB, respectively in both cases Germany's share is the biggest, the conclusion follows that Germany has to take the biggest financial burden and responsibility.

4. Conclusion

The strategic project for establishing a single European unit in a monetary union was meant to diminishing and even overcoming the economic differentiation between the countries involved. It turned out that in fact a single monetary unit in a heterogeneous union contributes to further deepening of the economic differentiation. When the sovereign debt crisis in the euro zone began, a framework for financial assistance was created which tends to differentiate between bail-in and bail-out. If financial assistance in a member country is needed, bail-in and bail-out are measures to be considered.

The term bail-in appeared for the first time on the pages of The Economist. Bail-in means that the borrower's creditors bear some of the burden of the necessary financial assistance. Usually a part of the value of the creditors' assets is written off. Bail-out involves a governmental /financed by the taxpayers/ or external /international/ financial rescue operation for the borrower. **It is considered that in any future rescue operation in the monetary union a bail-out will be accompanied or preceded by a bail-in.** /What is a bail-in?, The Economist explains, www.economist.com (07.04.2013)/ This was the case with the official rescue operation for Cyprus.

Bailout mechanisms really have the potential to help overcoming liquidity problems – really providing liquidity buffers in certain periods for troubled economies and financial institutions. This short-term potential comes into contradiction with medium and long-term implications like increasing moral hazard and creating unsound dependency of the ineffective economies on donor – countries. Germany's biggest financial contribution in the European bailout mechanisms works for the dominant German position. Even the weakness of the euro after the beginning of the sovereign debt crisis in the monetary union favored financially the German export business. At the same time Greece and Portugal, for example, could not take advantage of the weakness of the euro. The problems of their economies are fundamental which means that the currency factor cannot be of great significance. Being in the role of beneficiaries of international financial assistance in the European monetary union for years, the ineffective economies are in danger of long-term financial dependency. **The author's view is that in this way the bailout mechanisms contribute to strengthening and stabilizing the**

economic differentiation between member states in the European Monetary Union. At the same time the process of stabilization and further development of the euro zone requires diminishing economic differentiation, achieving a more homogeneous union and real convergence between member countries.

The contemporary crisis processes in the European monetary union have made evident that the rules and regulations formulated and accepted on international level concerning budget discipline, have turned out to be ineffective. Up to this moment the only working instrument for imposing budget discipline and forcing countries into accepting to carry out the necessary structural reforms are the financial markets and more specifically the increasing cost for market financing of public debts. **This instrument can be called effective control by the financial markets. An investigation presents a conclusion that this instrument works only in the absence of bailout mechanisms.** /Bordo, M., Jonung, L., A Fiscal Union for the Euro – Some Lessons from History, www.voxeu.org (21.09.2011)/ *In fact only the increasing market spreads on sovereign debts can discipline governments in their budget policy.*

The author's view is that the role of the bailout mechanisms in the European monetary union will need further investigation of its longer-term implications.

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ULOGA ANTIKRIZNOG MEHANIZMA U EVROPSKOJ MONETARNOJ UNIJI

Rezime: U radu se diskutuju inicijalne mere usmerene na sprečavanje širenja finansijskih poremećaja kroz Evropsku monetarnu uniju, konkretnije, instrumente čija je uloga hitna i privremena finansijska pomoć u cilju prevazilaženja problema likvidnosti u periodu najintenzivnije krize javnog duga. Kasnije je osmišljen Mehanizam za stabilizaciju Evrope, stalni antikrizni mahanizam, čiji se mandat dalje analizira u radu. Autor iznosi stav da dati antikrizni mehanizam može imati isključivo kratkoročne efekte. U daljoj perspektivi efekti ovog mehanizma će naverovatnije biti negativni, naročito kada se ima u vidu razvo monetarne unije, upravo zbog toga što ovakav antikrizni mehanizam može uvećati moralni hazard i stvoriti "nezdravu" zavisnost manje efikasnih privreda od privreda – donatora. U stvari ovakav antikrizni mehanizam mogao bi doprineti jačanju ekonomske diferencijacie između država članica EMU.

Ključne reči: Evropska Monetarna Unija, antikrizni mehanizam, Evropski mehanizam stabilizacije