The European Stability Mechanism

May 2014
A comprehensive response to the euro crisis

1) **Significant fiscal consolidation and structural reforms at national level**
   - Macroeconomic imbalances are disappearing

2) **Improved economic policy coordination in the euro area**
   - More comprehensive and stricter rules for policy coordination

3) **Institutional innovations: financial backstops and OMT**
   - EFSF and ESM have disbursed €229.6 bn to Ireland, Portugal, Greece, Spain and Cyprus
   - Potential concerted ESM – ECB intervention possible

4) **Reinforcing the banking system**
   - European banks have Core Tier 1 capital ratio of 9% or more
   - Moving towards Banking Union
EFSF/ESM programme countries are the reform champions

- Greece, Ireland, Portugal and Spain are in top 5 of 34 OECD countries with regard to implementation of structural reforms

<table>
<thead>
<tr>
<th>Ranking in OECD report</th>
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<tbody>
<tr>
<td>1. Greece</td>
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<td>2. Ireland</td>
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<td>3. Estonia</td>
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<td>4. Portugal</td>
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<td>5. Spain</td>
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“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 2013 (OECD Report)

Source: OECD report Going for Growth 2013
Ranking takes into account responsiveness to OECD recommendations on structural reforms in key policy areas
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 *2013 Euro Plus Monitor* published by the Lisbon Council

The ranking comprised 17 euro area countries + UK, Poland and Sweden
The strategy is delivering results - competitiveness

- Divergences within EMU are declining
- Competitiveness is improving in all Member countries having requested EFSF/ESM financial assistance

Nominal unit labour costs, whole economy (2008=100)

Current Account Balance (as % of GDP)

Source: Eurostat, EC European Economic Forecast - Spring 2014
The strategy is delivering results - fiscal

Fiscal balance, euro area Member States
(as % of GDP)

Source: European Commission, European Economic Forecast – Spring 2014

* Actual figure for Ireland in 2010: -30.6%
The strategy is convincing the market

10-year government bond yields

Source: Bloomberg
... and allowing countries to once again borrow at sustainable rates

**Ireland**
- Successfully regained market access with the issue of a 10-year bond in March 2013; new issue in January 2014
- Interest rates have fallen (for 10y bond) from 15.15% in July 2011 to 2.7% in May 2014

**Portugal**
- Successfully returned to markets with the issue of a 10-year bond in May 2013
- Interest rates have fallen (for 10y bond) from 16.6% in Jan. 2012 to 3.6% in May 2014

**Spain**
- Maintained access to long-term capital markets
- Remained a regular long-term borrower
- Interest rates have fallen (for 10y bond) from 7.56% in July 2012 to 2.9% in May 2014
Latest euro area growth figures are encouraging

- **GDP growth positive again** in Q2 – Q4 2013 after 6 quarters of economic contraction
- **Euro area GDP** rose by 0.3% in Q4 2013
- **Industrial production** in euro area grew 0.2% in February 2014
- **Business activity** and **consumer confidence indicators** in euro area rose significantly in final months of 2013
- European Commission forecast for growth in euro area: **1.2% in 2014 and 1.7% in 2015**

Source: Eurostat, European Commission
Improved economic policy coordination in the euro area

- 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 rules** are to be introduced in national legal systems
  - **European Semester**: yearly cycle of economic policy coordination
  - Stronger emphasis on **avoiding macroeconomic imbalances**
  - New focus: **avoid “spillovers”** of bad economic policy from one euro country to another
EFSF and ESM: mission and scope of activity

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*

All assistance is linked to appropriate conditionality

EFSF and ESM finance their activity by issuing bonds or other debt instruments
EFSF/ESM lending and assistance

- **Support for five countries** *(EFSF: Ireland, Portugal, Greece; ESM: Spain and Cyprus)*
  - Combined lending capacity: €700 bn
  - Committed amount to the five countries: €238.6 bn
  - Disbursed so far: €229.6 bn
  - Macroeconomic adjustment programmes for Greece and Cyprus
  - EFSF may no longer engage in new financial assistance programmes (as of 1 July 2013)
  - Ireland exited its EFSF financial assistance programme on 8 December 2013
  - Spain exited ESM programme in support of the banking sector on 31 December 2013
  - Portugal announced a “clean exit” from its financial assistance programme

- **Potential concerted ESM – ECB intervention (Outright Monetary Transactions/OMT)**
  - ESM programme provides conditionality
  - The ECB could engage in secondary market purchases
“Clean exit” from financial assistance programmes by Ireland and Spain

■ Ireland
  - EFSF financial assistance programme concluded on 8 December 2013
  - Ireland received a total of €67.5 bn in loans from international lenders; €17.7 bn from the EFSF
  - Thanks to international support and a macroeconomic adjustment programme, Ireland’s GDP is expanding and unemployment has been declining
  - Ireland’s banking sector has undergone significant correction (downsizing, recapitalisation and deleveraging)

■ Spain
  - ESM financial assistance programme (loan to Spanish government for bank recapitalisation) concluded on 31 December 2013
  - Spain received €41.3 bn in loans (debt securities) from the ESM
  - Thanks to ESM assistance, banks have strengthened their capital, improved access to private funding and regained soundness
  - Successful bank restructuring has paved the way for Spain’s real economy to rebound
Reinforcing the banking system

- Europe is pushing ahead with financial market reforms
  - The progressive implementation of the “Basel III” capital accord has started

- EU established three new European supervisory authorities – EBA, EIOPA and ESMA

- The new ESRB (European Systemic Risk Board) for identifying and monitoring macro-prudential risks is functioning

- EBA decided higher capital requirements for banks – Core Tier 1 capital ratio is raised to 9%

- Banks increased their capital base by over €200 billion in 2012 and by €450 billion since 2008
  - ¾ through fresh capital
  - ¼ through decreasing assets

- Programmes for Ireland, Greece, Portugal and Cyprus include assistance for bank recapitalisation, €41.3 billion has been transferred to Spain to support the banking sector

- Problem: renationalisation of the capital market in the euro area
Renationalisation of capital market in euro area

- Dispersion of bank lending rates to the non-financial private sector ...
- ... and of overall financing costs for the corporate sector has increased considerably across the euro area throughout the recent crisis period

Source: Haver Analytics, ECB
Last observation: December 2013

Bank lending rates to non-financial firms, small loans (%)

European Stability Mechanism
Towards Banking Union

- **Single Supervisory Mechanism (SSM)** for euro area banks will be operational in November 2014.

- **Bank Recovery and Resolution Directive (BRRD)** will create a uniform framework for bank recovery at national level.

- **Single Resolution Mechanism (SRM)** with **Single Resolution Fund (SRF)**: preliminary agreement between European Parliament and Council of the EU reached in March 2014.

- **ESM Direct Recapitalisation Instrument** will be operational once SSM enters into force and euro area MS unanimously approve.

- Harmonisation of **national deposit guarantee frameworks**
Measures to boost growth in EU

- Progress in resolving the euro crisis **removes important uncertainties for investors, consumers, banks and financial markets**
- **EFSF/ESM programmes include long list of structural reforms**
- **Coordinated action at national and EU level for Growth and Jobs**
  - Member States take action to achieve specific competitiveness goals
  - Member States coordinate policies to pursue growth-friendly fiscal consolidation and to restore lending to the economy
  - European “Marshall Plan” against youth unemployment
- **European Investment Bank (EIB)**
  - 90% of its lending supports sustainable growth and job creation
  - €10bn capital increase, which will raise lending capacity by €60 bn
  - EU-EIB Project Bond Initiative
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