European Stability Mechanism

THE CASE FOR A LOAN-BASED EURO AREA STABILITY FUND

Florian Misch & Martin Rey

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Link to Discussion Paper:
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European Stability Mechanism
6a Circuit de la Foire Internationale
L-1347
Luxembourg

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CASE FOR FISCAL STABILISATION CAPACITY WELL ESTABLISHED, BUT NOW MORE URGENT

- A long-standing case…
  1) Under asymmetric shocks / asymmetric exposure
     - Cannot be addressed by monetary policy, and fiscal space could be insufficient
  2) Large common shock & similar exposure
     - Monetary and national fiscal space may be insufficient

- ...and external shocks are likely to become more common, thereby increasing urgency

OUR PROPOSAL: A EURO AREA STABILITY FUND

- Administered by the ESM
- Activation condition jointly evaluated by ESM and EC, in liaison with ECB
  - Activated in case of large external shock
  - Eligibility criteria and safeguards
- Provides cheap loans with up to 10yr maturity
- Loans up to 4% of national GDP
- EUR 250 bn overall envelope

Activation ✓

Quantitative + expert judgement

\+ **Eligibility** ✓

No MAP, EDP or EIP + DSA

\+ **Take Up** ✓

Request from MS

TWO GUIDING QUESTIONS FOR EVALUATION

1) *Benchmarking:*
   How does the stability fund compare against best practice principles?
   ➔ Conceptual evaluation and comparison to other proposals

2) *Simulation:*
   How would have the stability fund fared had it existed in the past?
   ➔ Frequency analysis; loan portfolio over time; stabilisation effects

TYPOLOGY OF EXISTING PROPOSALS

	Insurance Fund	Rainy-day Fund	Revolving Fund
Transfer	Grants	Grants and Loans	Loans
Risk sharing	Full	**Limited**	Full
Financing	Contributions	Contributions	Market financing
Examples	Most academic proposals	Few academic papers	**Stability Fund**; SURE; EISF

BENCHMARKING THE STABILITY FUND

	Insurance fund	Stability fund
Risk **of moral hazard and permanent transfers**	**High** (requires special design features like clawback mechanism)	**Low** (by design as loans need to be repaid)
Cost & time of **implementation**	**High** (complexity in design complicates implementation; accumulation of capital)	**Low** (no up-front capital needed, no accumulation of reserves necessary)
Cost of **participation**	**High** (annual contributions)	**Low** (only increase in contingent liabilities)
Stabilisation effects	**Ambiguous ex-ante** (claw back mechanisms undermine impact of loans, effects depend on contribution structure)	**Ambiguous ex-ante** (loans need to be paid back, but no pre-funding necessary, effects depend on structure and terms of loans)

SIMULATION METHODOLOGY OF LOAN DISBURSEMENTS

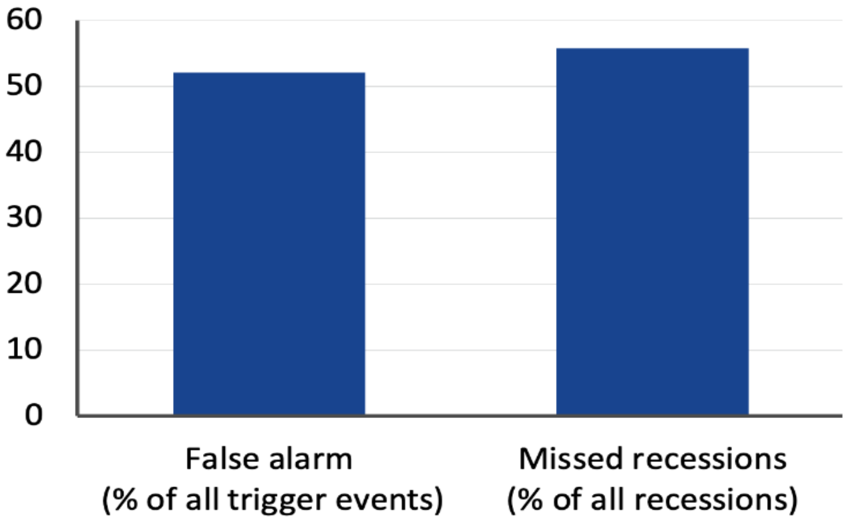
- Assume existence of stability fund since 2000
- Use of quarterly data
- Simulate disbursements as function of
  - Historical eligibility (MAP, EDP, etc.)
  - Quantitative trigger (unemployment condition)
  - Decision to request loan (loans vs. market funding)
- Benchmarking UE trigger against ‘perfect’ recession indicators available ex-post
  - GDP-based
  - Eurostat dating

SIMULATING LOAN DISBURSEMENTS AND PORTFOLIO

- UE trigger alone is unreliable

➔ Activation based on numerical trigger *and* expert judgement

Precision of Unemployment Trigger

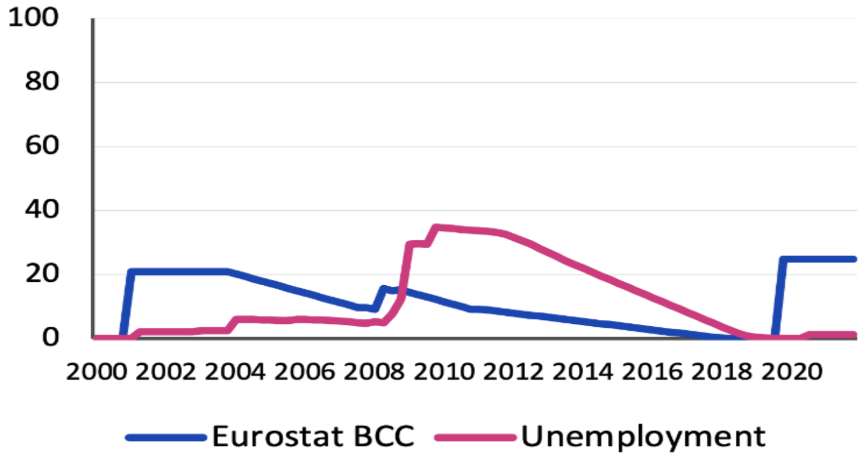


Source: Authors' compilation

- Loan portfolio would not have exceeded 40% of maximum envelope

➔ ESM's lending capacity sufficient; no additional resources

Size of Loan Portfolio
(Percent of 250 Billion)



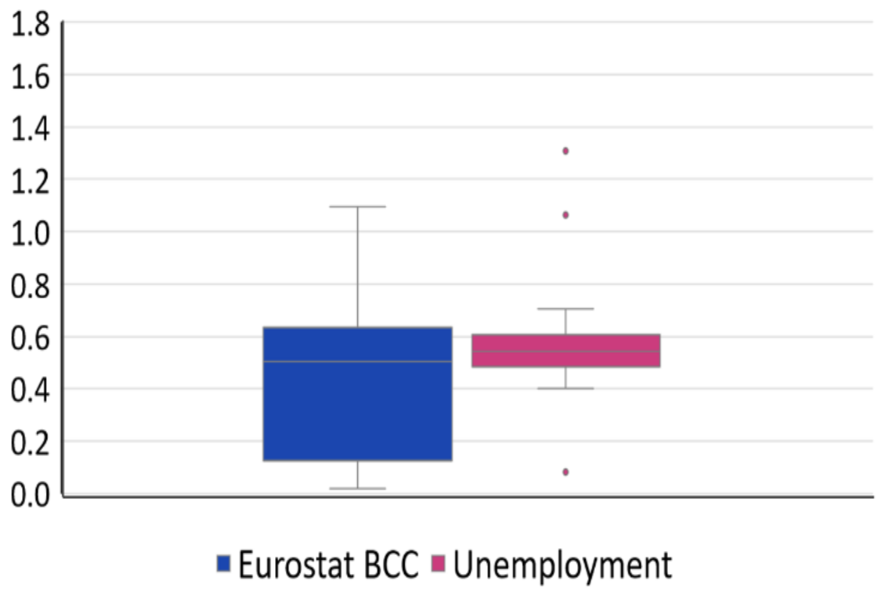
Source: Authors' calculation

STABILISATION THROUGH ADDITIONAL FISCAL SPACE

- Metric: fiscal savings relative to market financing
  - Depend on loan parameters, market conditions and use of loans (established methodology at ESM)
- Additional fiscal space can be significant
  - Savings can exceed 1% of GDP
  - Large relative to size of loan (4% of GDP)
- Grants from simple insurance fund not always greater than stability fund loans
  - Assumption: Simple insurance with claw-back mechanism in place
  - Rationale: Net present value of fund and loan can differ depending on interest rate and discounting environment.

Distribution of Savings by Trigger Type

(As a % of GDP)



KEY TAKE AWAYS

- Long-standing case for fiscal stabilisation capacity, but
  - External shocks are likely to be more common going forward
  - Opportune time to discuss
- Proposal for ESM-hosted, loan-based stability fund
  - Easy to implement
  - No need for additional resources
  - Addresses moral hazard by design
- Relationship to other proposals
  - Can be superior to many academic proposals, but political stigma ignored
  - Complementary to other proposals which would take more time to set up