EFSF 2.0 or the European Monetary Fund

Daniel Gros* and

Thomas Mayer**

Introduction

In early 2010 we proposed the creation of a "European Monetary Fund". Later, in May of that year the European Financial Stability Facility (EFSF) was created and became a funding vehicle without being a real "fund" (i.e., an organisation with its own professional staff and professional autonomy). This may change now given that the French and German leaders have proposed in their joint letter to the President of the European Council, Herman Van Rompuy, increasing the analytical capacity of the EFSF, which until now had relied almost exclusively on the work of the Commission and the detailed decisions of its board of finance ministry representatives.

It seems as if the EFSF is now becoming in institutional terms more similar to the IMF. But the changes to the EFSF's field of action have been even more impressive, especially since the European Council of 21 July 2011, whereupon French President Nicolas Sarkozy proudly declared that euro area leaders "have agreed to create the beginnings of a European Monetary Fund".[1]

Unfortunately the decision to allow the EFSF to engage in secondary market purchases and provide precautionary financing was not followed by a reduction in market tensions. On the contrary, starting in early August 2011, the crisis became even more virulent, spreading to Italy and Spain.

In this paper, we argue that the crisis worsened primarily because the decisions of 21 July were incomplete on three fronts:

- Given the cascade financing structure, there is an even lower de-facto limit on the borrowing capacity of the EFSF than set by the governments;
- The largely overlooked demand for collateral by some creditors resulted in the ill fated Finnish-Greek bilateral agreement.
- Given its borrowing limits, it was never clear how the EFSF could engage in substantial secondary market purchases in case of a liquidity crunch in a bond market (a key point, considering the reluctance of the ECB to engage in large-scale bond purchases of financially troubled governments).

The purpose of this contribution is to show how all three weaknesses can be addressed by a combination of two measures:

- Registering the EFSF as a bank, thus giving it access to the ECB (or rather euro-system) refinancing for its secondary market purchases, if required to protect financial stability.
- The introduction of "VAT bonds" to finance adjustment programmes for countries in difficulties and assist debt restructuring if otherwise unavoidable.

A Greek warning

Canaries used to be kept in coal mines because they die faster than humans when exposed to dangerous gases. When the birds stopped singing, miners knew that it was time to prepare for an emergency. Greece, as it turns out, was the euro zone's canary. It was nevertheless resuscitated, and a small rescue mechanism was set up to revive a further canary or two – but beyond this the warning was ignored. The miners kept on working. They convinced themselves that this was the canary's problem.

The problems of Greece should have been recognised as the first manifestation of a general problem, namely that the global crisis was spreading to public debt as capital markets refused to refinance exces-

* Centre for European Policies Studies, Brussels.
** Deutsche Bank, Frankfurt.
[1] See: http://www.elysee.fr/president/les-actualites/communiques-de-presse/2011/zone-euro-finances-publiques-la-lettre-du. 11797. html

sive levels of public debt, especially in the euro zone, whose members can no longer rely on central bank support.

This has become particularly evident since the European Council of July 2011 – the meeting that was supposed to end the crisis by settling the Greek case with a mixture of generous long-term financing at low interest rates and some private sector rescheduling and restructuring.

The Greek public might not realise it, but it has received preferential treatment from the EU. With the decisions taken at the July European Council, Greece essentially has all its financing needs arranged for the next decade and is assured of paying less than 4 percent on the new debt it is incurring.[2] The two other countries with a programme, Ireland and Portugal, will have similarly low interest rates and loans with extended periods of maturity, but they are still expected to face the test of the markets in a few years' time.

The spread of debt fears

But while Greece, Ireland and Portugal obtained lower rates for their official long-term financing, Spain and Italy experienced a surge in their borrowing costs: before the intervention of the ECB they were paying more than 6 percent for ten-year money.

It is clear that these countries cannot be expected to provide billions of euros in credits to Greece (and Portugal and Ireland) at approximately 3.5 percent when they themselves are paying so much more. Europe's leaders wanted to be generous to Greece, but the supply of cheap funds is limited.

Not everybody can be served this way. How much would be needed for a hypothetical programme for these two countries? Assuming that they would need about the same amount in proportion to their GDP as Greece, a first, short, programme for these two countries would probably need to amount to about EUR 800 billion (equal to the financing needs of these two countries over the next three years), counting on an additional EUR 240 billion from the IMF. A second, longer-term programme for these two countries would require an additional EUR 1 trillion (again taking Greece's needs as a proportion of GDP as a guide and assuming that the IMF at that point would no longer be able to contribute substantially).

The total amount needed from European sources for a full, longer-term "bail out" of the entire periphery (Greece, Ireland, Italy, Portugal and Spain – or GIIPS) would thus be more than EUR 2 trillion, or more than 20 percent of the euro zone's GDP (Table 1). For purposes of comparison, consider that the total EU-27 national contribution to the EU 2011 budget amounts to EUR 108 billion, the ECB total assets to EUR 1.9 thousand billion and its paid-up capital to EUR 5 trillion.

Obviously these calculations border more on economic fiction than on a concrete possibility. And if Spain and Italy were actually to lose market access, the euro zone would be close to the breaking point anyway.

Table 1

Scenarios for hypothetical full bail-out of the entire euro zone periphery (billions of euro)

	Total European contribution	External resources	Total EFSF without IMF
1 Greece	80	30	
2 Ireland	40	23	
3 Portugal	52	26	
4 Greece: financing until 2014 (with PSI)	71	33	
Total 1–4	**243**	**112**	
5 Ireland: financing until 2014	70	–	
6 Portugal: financing until 2014	76	–	
Total 1–6	**389**	**112**	
7 Spain: short-term financing plan	325	162	487
8 Italy: short-term financing plan	477	238	715
Total 1–8	**1,190**	**913**	**1,590**
9 Spain: long-term financing plan	485	–	485
10 Italy: long-term financing plan	715	–	715
Total 1–10	**2,390**	**913**	**2,790**
as % of euro zone GDP	24		28
as % of peripheral euro zone public debt	76		89
as % of euro zone bank assets	7		9

Source: Authors' own calculations.

[2] See: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/123978.pdf

The EFSF was designed for a peripheral crisis

In particular, the euro zone rescue fund, the European Financial Stability Fund (EFSF), simply does not, and will not, have enough funds to undertake the massive bond purchases required to stabilise markets. It was sized to provide emergency financial support only to small peripheral countries such as Greece, Ireland and Portugal.

Moreover, the structure of the EFSF makes it vulnerable to a domino effect.

- The rules of the EFSF imply that a country that encounters financial difficulties and asks for support from the EFSF can "step out", i.e., no longer provide guarantees for any further debt issuance by the EFSF (See Art. 2(7) of the EFSF Framework Agreement).[3]
- Even if it is not explicitly regulated, it can be expected that a country facing high borrowing costs (as in the case of Italy and Spain if rates stay at crisis level) will step out as guarantor and only the core Eurozone members would remain to back the EFSF.

At this point, the debt burden on the core countries would become unbearable. Since the step-out mechanism modifies the key percentage in the EFSF, the relative weights of the two biggest countries, France and Germany, continue to increase with each new country needing financial assistance. Table 2 shows how the share of Germany would increase to about 43 percent of the total if all five GIIPS were to need help and thus "step out".

Another implication of the step-out mechanism is that each time a country "steps out", the effective lending capacity diminishes, as shown in Table 3. This implies that the EFSF would have to have an initial volume of over EUR 4 trillion in order for the remaining guarantees to be sufficient to finance Spain and Italy. This colossal amount is also far greater than the amount recently agreed for the ESM, which was intended as the last and definitive EU answer to the crisis: it, in fact, will have (only) a total subscribed capital of EUR 700 billion, with an effective lending capacity of EUR 500 billion.

[3] See http://www.efsf.europa.eu/attachments/efsf_framework_agreement_en.pdf

Table 2

Increasing weights of Germany and France (in %)

Step out sequence	Germany	France
Starting point	27.1	20.4
Step out: Greece	27.9	21.0
Step out: Greece and Ireland	28.4	21.3
Step out: Greece, Ireland and Portugal	29.1	21.9
Step out: Greece, Ireland, Portugal and Spain	33.4	25.1
Step out: Greece, Ireland, Portugal, Spain and Italy	42.9	32.2

Source: Authors' own calculations.

Table 3

Progressive erosion of the EU effective lending capacity (billions of euro)

Step out sequence	EFSF	Extended EFSF
Starting amount	250	440
Step out: Greece	243	428
Step out: Greece and Ireland	238	421
Step out: Greece, Ireland and Portugal	232	409
Step out: Greece, Ireland, Portugal and Spain	203	357
Step out: Greece, Ireland, Portugal, Spain and Italy	158	278

Source: Authors' own calculations.

Dangers of applying the periphery solution to the core

This implies that a larger EFSF is not the solution; if anything it could accelerate the fall of the dominoes. The position of the French government – that the EFSF should be increased – does not make sense even from an insular French point of view because financial markets have understood this risk and are driving up borrowing costs for France – the core country most in danger of losing its AAA rating. At the moment France provides 22 percent of EFSF's total guarantees, around EUR 90 billion, destined to become 158 after the ratification of the extended EFSF. But if France loses its triple-A status and then has to "step out" of the EFSF, only Germany (and some of its smaller neighbours) would be left to carry the whole burden. This would not only be politically unacceptable but also economically impossible – the Italian government debt alone is equivalent to the entire GDP of Germany.

At the moment the extended EFSF's AAA rating relies on those of six countries: Austria, Finland, France, Germany, Luxembourg and Netherlands, which together provide exactly EUR 450 billion (Table 4). If France lost their AAA rating, the remaining five coun-

Table 4

Actual ratings of euro zone members (August 2011)

Euro area country	Moody's	S&P	Fitch	EFSF actual guarantees (in %)
Austria	Aaa	AAA	AAA	3.0
Belgium	Aa1	AA+	AA+	3.7
Cyprus	A2	A–	A–	0.2
Finland	Aaa	AAA	AAA	1.9
France	Aaa	AAA	AAA	21.9
Germany	Aaa	AAA	AAA	29.1
Greece	Caa1	CCC	B+	step out
Ireland	Baa3	BBB+	BBB+	step out
Italy	Aa2	A+	AA–	19.2
Luxembourg	Aaa	AAA	AAA	0.3
Malta	A1	A	A+	0.1
Netherlands	Aaa	AAA	AAA	6.1
Portugal	Baa1	BBB–	BBB–	step out
Slovakia	A1	A+	A+	1.1
Slovenia	Aa2	AA	AA	0.5
Spain	Aa2	AA	AA+	12.8

Sources: Moody's, S&P, Fitch and author's calculations.

ties would have to raise their guarantees in order to maintain the same rating level: Germany to EUR 325 billion, the Netherlands to 69, Austria to 33, Finland to 22 and Luxembourg to 3. Undoubtedly the path of parliamentary ratification of the new EFSF would become more difficult, considering the reactions of respective national taxpayers. The alternative would be an increase in borrowing cost; after all, if America is rated double-A plus, why can't the EFSF be double-A plus? However, higher borrowing costs for the EFSF would translate to higher funding costs for countries receiving support, reducing the prospects for retaining or restoring their solvency.

Towards an effective European Monetary Fund

Thus, the financing of the EFSF, has become the central issue for the euro crisis as it reaches the core. Under the impression of a seemingly insolvable problem more and more observers argue that "euro bonds" are the only way out. Proponents often do not specify what is meant by this, but the term "euro bonds" usually means a bond which is jointly and severally guaranteed by all euro area member states.

In some variants of the euro bond proposals member states could issue at least part of their own debt in the form of euro bonds. The issuance of such bonds on a large scale would of course amount to a huge transfer of risk (from the creditor to the debtor countries). Moreover, a fiscally sound small country might in the end be liable for a large part of euro area public debt should some of the larger countries simply refuse to pay up. We do not support this approach. However, we believe that some limited form of a common bond could be used to finance the rescue operations of the EFSF.

Thus, we propose a two-pillar structure to finance the embryo of a European Monetary Fund as it exists in the form of the EFSF today. We propose that rescue operations which involve at least the danger of insolvency are financed via a fiscal instrument, whereas pure liquidity support in the form of secondary market bond purchases to secure financial stability is financed by rediscounting secondary market operations at the ECB. In short:

- Department 1: it would manage and fund adjustment programmes and, in case adjustment is impossible without debt reduction, facilitate orderly debt restructuring along the lines of the Brady Plan. Adjustment funding and help for debt restructuring would be backed fully by the support from member states and from VAT bonds.
- Department 2: the financial stability department would counter liquidity logjams in euro area sovereign bond markets that jeopardise financial stability by intervening in secondary markets For secondary market purchases it could access the ECB's refinance window, provided the ECB and the ESRB agree that this is needed to avert systemic risk.

Department 1: VAT euro bonds instead of euro bonds?

There is an alternative to the actual system of bilateral limited guarantees. The EFSF could finance its rescue operations (as argued above, only those where there is at least a remote danger of insolvency) by issuing bonds which are backed jointly and severally by the VAT revenues (and only these revenues) of all euro area member countries.

The EFSF should be able to call up rather large resources this way given that in the euro area total VAT revenues amount to about EUR 700 billion annually (about 7 percent of GDP), which is already

substantially more than the EUR 440 billion foreseen at present.[4]

VAT bonds would be different from euro bonds in two important aspects:

- These bonds would not be backed by the full faith of all member states, but only their VAT revenues, which limits the risk for the fiscally stronger member countries.
- No member country could ever be asked to pay more than its current VAT revenues for the service of the VAT bonds issued by the EFSF. This also limits the risk, especially for smaller member countries which might otherwise be liable for a large batch of euro bonds if the larger member countries were to refuse to pay up.

Moreover, VAT revenues, which at present are all national, could (and should) at the same time also be used to secure debt service by programme country to the EFSF. Countries under an EFSF/ESM programme would have to submit their local VAT to EU control, with a certain, pre- specified part of the revenues no longer accruing to the national treasury, but going directly to the EFSF (or future ESM) until the loans have been fully repaid.

For example, in the case of Greece, VAT revenues amount to 6.5 percent of GDP, or about EUR 13 billion annually, which is more than the total paid by the Greek government on its debt. Even with only one half of this sum Greece could guarantee the interest payments on more than 100 billion in loans. Of course the debtor country would have to agree that any change in VAT rates or the definition of the base be subject to a veto by the EFSF/ESM.

The VAT bonds would thus be essentially some variant of covered bonds which limits the risk to the creditor countries. Given that for all countries VAT revenues are larger than interest on debt, the value of the collateral should be enough to provide creditors with a very high degree of security, thus justifying a rather low interest rate. For the euro area as a whole VAT revenues amount to over 6 percent of GDP whereas interest payments on government bonds are less than 3 percent of GDP.

It is clear that VAT bonds cannot solve all problems. In particular the de facto seniority of VAT bonds would of course lower the value of the remaining government bonds, which are guaranteed only by the "general obligation" of the government. However, as the recent case of Finland's demand for collateral from Greece shows there is anyway a tendency by the creditor countries to seek out some security for their lending to potentially insolvent countries.

In sum, using VAT revenues as a way both to underpin "euro rescue bonds" and repayment by debtor countries would thus have a number of advantages:

- It would limit the risk for the fiscally virtuous countries as argued above. Given that the maximum at stake is VAT revenues.
- The base for VAT has already been to a large extent harmonised and the tax rates which are fixed by member countries are subject to a corridor ensuring in practice a fair amount of harmonisation of VAT revenues (around 6–7 percent of GDP).
- VAT taxes only consumption. A country with a debt problem needs in the first instance to increase exports, which are not subject to VAT. Export led growth would thus not lead to higher debt service. Only once domestic consumption starts to grow again would debt service increase.
- VAT revenues could be "unionised" for programme countries, providing a further guarantee for the creditors.

Table 5

Private consumption and VAT (% of GDP, and tax rates)

	VAT/GDP	Private consumption/GDP	Effective VAT rate on consumption (= VAT revenues/consumption)	Memo item: Interest service on debt as % of GDP
EU-27	6.7	58.3	11.5	2.7
EZ-16	6.6	57.6	11.5	2.8
Germany	7.4	58.9	12.6	2.4
Ireland	6.4	50.6	12.6	3.3
Greece	6.3	73.5	8.6	5.5
Spain	4.1	56.6	7.2	1.9
France	6.8	58.0	11.7	2.5
Italy	5.7	60.0	9.5	4.4
Portugal	7.1	65.8	10.8	3.0

Sources: Eurostat and AMECO, 2009 data (2010 for interest service).

[4] With private consumption amounting to about 55 percent of euro area GDP on average, VAT should yield about 10 percent of GDP in revenues at a full rate of close to 20 percent. The existence of zero-rated goods lowers the yield to about 7 percent of GDP, but the differences among member countries in VAT revenues seem to be manageable.

The introduction of VAT bonds should, of course, be complemented by strengthening even further VAT base harmonisation. But this is already on the official agenda. Euro area countries would also have to satisfy certain general rules on their VAT rates and the VAT base relative to consumption to ensure that no country can escape its obligations by either arbitrarily lowering VAT rates or increasing the array of goods and services subject to lower or zero VAT. Table 5 shows that Spain, for example, stands out as collecting an unusually small amount of VAT revenues.

VAT bonds, which would extend the covered bond concept to public debt, concentrate on the one area of taxation which is already largely harmonised and with limited risks for the creditor countries.

Department 2: face liquidity problems

The second department – we will call it the financial stability department – would counter liquidity logjams in euro area sovereign bond markets by intervening in secondary markets (see Table 6 for European bank exposures to potentially risky government debt). The European Council of 21 July 2011 opened the way for the EFSF to buy bonds in the secondary market. So far it has been envisaged that the EFSF could merely, as an exception, intervene in the primary market in the context of a programme with strict conditionality. The new instrument is highly desirable given the current state of uncertainty in the markets, but it would remain meaningless without an increase in the lending capacity of the EFSF. In fact, after providing full financing until 2014 for the GIPs, an extended EFSF would have practically no resources left, given that its lending capacity would be about EUR 409 billion, not much more than the EUR 390 required for the GIPs.

Smaller secondary market intervention in case of limited liquidity gaps could be funded with EFSF's resources (similar to the operations in the first department). However, in case of a big liquidity crunch, the EFSF could access ECB facilities by borrowing against the government bonds it is purchasing as collateral. Assuming that the ECB insists on the top quality of the assets it takes for collateral – as, for instance, assured by a high rating – it would ensure that it only lends in case of a liquidity crunch and not when a country suffers insolvency. The decision to intervene to buy national government bonds in order to protect financial stability would be taken by the EMF, based on expert assessments and under the supervision of the finance ministers in conjunction with the ECB (as already foreseen in the conclusions to the European Council of 21 July) and the European Systemic Risk Board. Hence, the ECB, whose task is not to determine fiscal policy in specific countries, would again be able to look after price and financial stability for the euro area as a whole. Moreover, credit risk would fall on the EFSF's balance sheet.

Our proposal is institutionally far superior to the present arrangement, where the ECB uses its SMP to pressure the Italian government into reforms and fiscal adjustment. There is no representation of the European tax payers on the Governing Council of the ECB, which might have a tendency to be overly concerned about instability in financial markets and have too little regard for the interests of taxpayers.

The ECB would still be able to control liquidity developments for the entire euro area because once financial markets have returned to normal it could simply stop its policy of full allotment. At this point any refinancing by the EFSF would simply crowd out financing to other banks and thus not increase area-wide liquidity.

Table 6

European bank exposure towards peripheral countries (only banks included in 2011 stress test)

Country	Sovereign direct long exposure	Sovereign direct long exposure minus loans and advances	Net direct positions
Greece	90.1	79.0	82.7
Ireland	19.3	16.5	15.8
Portugal	40.2	32.8	37.6
Subtotal	149.6	128.3	136.1
Spain	287.0	203.2	264.4
Italy	325.9	265.7	286.3
Total periphery	**762.5**	**597.1**	**686.8**

Source: European Banking Authority 2011 EU-wide Stress Test Aggregate Report, London.

Backstopping the EFSF via the ECB – i.e., creating an EMF – would have the advantage over the current situation in that it leaves the management of public debt problems in the hands of the finance ministries and provides them with the liquidity backstop that is needed when there is a generalised breakdown of confidence. In a crisis of confidence the fundamental problem of banks and governments is always one of liquidity. This is exactly when a lender of last resort is most needed.

The ECB is the only institution that can provide the required "lending of last resort" quickly and in convincing quantities. It would of course be much better if the ECB did not have to bail out the European rescue mechanism, but in this case one has to choose between two evils. As long as it is temporary, even a massive increase in the ECB's balance sheet constitutes a lesser evil than a breakdown of the euro zone financial system.

But would our proposal be consistent with the European treaties? We think so. Article 123, §1 of the AEUV forbids direct ECB credit to public institutions so as to avoid monetary financing of fiscal deficits. However, Article 123, §2 exempts banks owned by the public sector from this prohibition. Thus, public banks such as the European Investment Bank or the German KfW (which extends the German contribution to the funds for the adjustment programme to Greece) have access to ECB windows. Moreover, Council Regulation no. 3603/93 of 13 December 1993 exempts the IMF and the balance-of-payments-assistance-facility (renamed to EFSM) from the prohibition of receiving ECB funds. Hence, we do not see a serious legal obstacle to giving emergency access to ECB funds to the department of the EMF charged with the prevention of financial crises through intervention in secondary sovereign bond markets (see Annex for further discussion). To the contrary, we believe that our proposal would help to end a situation in which the ECB goes against the spirit of Article 123 and to avoid other currently discussed alternatives that would be politically and legally even more dangerous.

The dangers of introducing a political union without democratic legitimacy

Another solution touted by some has been to establish joint and several liability for euro area countries' debt by introducing euro bonds. The danger here is that holding tax-payers fully and unconditionally liable for spending decisions taken in other countries would most likely turn into a poison pill for the EMU. Political resistance against the EMU would rise in the stronger countries, eventually leading to a probable break-up of the EMU. Moreover, if the issuance of euro bonds were limited to a part of the national debt (say only 40–60 percent of GDP as proposed), highly indebted countries would immediately be forced into a debt restructuring as they could no longer find buyers for the part only guaranteed nationally.[5] Moreover, this approach would require a change in the EU treaties and would probably not be compatible with the German constitution.

Another variant of euro bonds would be for all euro area countries to provide a "joint and several" guarantee for the EFSF. This would have still have most of the political disadvantages mentioned above, but at least it would not create the additional problems of the blue/red bond proposal.

Whatever the variant, euro bonds would only make sense in a political union, and even then only when debt levels are low.[6] When starting debt levels are so high that the markets suspect a debt overhang euro bonds would amount to a large transfer of risk and, of course, strong expectations that future accumulations of debt will be treated in the same way.

No silver bullet

Bringing the EMU back to safe ground will of course only succeed if debt and deficits are reduced substantially. The financial crisis has clearly demonstrated that excessive debt loads and new deficits cannot be financed in anything but extremely benign markets. Countries that accumulate excessive debt will inevitably experience their "Minsky moment", when the rolling of this debt becomes impossible. For a stable EMU a long-term programme of debt reduction is a *conditio sine qua non*. However, debt reduction takes time, hence the need for an effective crisis management mechanism along the lines sketched out above. One without the other will not work, and the EMU will fail.

Our proposal will certainly dissatisfy the purists who regard the EMU as the re-birth of the gold standard. For the purists, our proposal amounts to a thinly veiled monetary financing of government debt. We would respond by saying that in the real world of today a pure gold standard-like arrangement will not work. In today's environment, the central bank needs to look after financial stability, which means that it must assume the role of a lender of last resort to banks and – because of the bank-government-debt nexus described above – also governments. The question is not whether, but how this role is performed.

[5] It could be different if, in case of default, part of the bonds – say that consistent with a 60 percent debt ratio – were guaranteed by the community of euro area states (through a provision in the bond covenant). In this case, the guarantee would only be effective in case of default while market participants would have a better idea of the recovery value.

[6] The federal government of the newly created US assumed the debt of the founding states because that debt was incurred while fighting for a common cause. This is certainly not the case in Europe today.

Annex: Legal issues

It might be argued that our proposal is not compatible with the prohibition of monetary financing of public bodies. However, this is not the case. The financial stability department of the EMF would essentially perform the same function as many private sector investment funds located (in Luxemburg and elsewhere) which are recognised as MFIs by the ECB and thus have access to normal eurosystem refinancing. These funds usually specialise in investing in euro area government bonds. The EMF could thus just create a special sub-vehicle ("distressed debt") whose purpose would be only to buy bonds on the secondary market. This vehicle could thus be operated just like any investment fund which invests in "distressed" debt (i.e., buy when yields are high). This sub vehicle would not extend credit to governments, it would only perform a function that is undertaken today by the eurosystem itself. There is thus no material reason why this activity should fall under the prohibition of the ECB to finance governments (Article 123 of the TFEU).

Article 123(1) states:

"Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments".

The key legal point in this article hinges on the status of the EFSF/EMF rather than on who ultimately benefits from the funding the ECB provides. The key issue would then be whether the EMF falls under any of the categories listed in Article 123 paragraph 1. Nowhere in Article 123(1) is there a reference to indirect funding or the purpose for which access to ECB funding is to be made; there is simply a prohibition on certain classes of entity from receiving ECB monetary financing.[7]

One could of course argue since the EFSF is fully owned by governments, it falls under the category of "public undertakings". However, Article 123(1) did not prevent the European Investment Bank (an EU body, but with a distinct legal personality, registered in Luxembourg, like the EFSF andowned by member states and the Commission) from obtaining refinancing from the ECB. In 2009 the EIB was recognised as an "eligible counterparty" by the ECB with access to ECB refinancing "as any other counterparty". As the ECB itself explains in a press release of 7 May 2009, this was "a natural complement to the EIB's financing initiatives". The reason is that paragraph 2 of the same article provides an exemption:

Article 123(2) reads:

"2. Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions."

This means that the EFSF (or perhaps only its financial stability arm) could benefit from the exception in Article 123 paragraph 2, if it were considered a publicly-owned "credit institution". Given that, as mentioned above, a number of investment funds are recognised as credit institutions there is no substantial reason why this should not be possible.

We note that in Germany the bilateral loans to Greece have been channelled via the KfW (Kreditanstalt für Wiederaufbau), which is also fully owned by the government and not a bank in the narrow sense of the word. However, the KfW is an "eligible counterparty" for the ECB as it is registered as an MFI. The KfW could thus refinance its lending to Greece (now over EUR 10 billion) via the ECB if it wanted to.

When in 2013 the ESM replaces the EFSF, it will become a public law institution. However, this should not be a real obstacle. The EIB provides a key analogy here, as the EIB is certainly a public body (and publicly-owned). In the ECJ's case law, the EIB is legally deemed an autonomous entity distinct from the EU but nonetheless a body intended to contribute towards the attainment of the Union's objectives. As a result, it falls outside the category of entities listed in Article 123 paragraph 1.

Finally, the most direct way to ensure that access by the EFSF/EMF to the refinancing operations of the ECB does not encounter legal obstacles would be to simply make a small change in Article 7 of Council Regulation (EC) No 3603/93 of 13 December 1993,[8] which exempts both the financing of the IMF and the financial assistance to non-euro area membership from the scope of Article 123. Given that financial assistance to euro-area member states will also soon have a treaty base (via the addition to Article 136, which has already been unofficially agreed), it would be appropriate to deal with the assistance to euro area member states. A change in the Council Regulation could be agreed quickly by the heads of state.

[7] Those arguing against our proposal focus on what the ECB funding to the EFSF will be used for, i.e., indirect government financing, but neither Article 123 nor Council Regulation (EC) 3603/93 mention indirect financing. Article 123 only refers to direct financing.

[8] "The financing by the European Central Bank or the national central banks of obligations falling upon the public sector vis-à-vis the International Monetary Fund or resulting from the implementation of the medium-term financial assistance facility set up by Regulation (EEC) No 1969/88 (4) shall not be regarded as a credit facility within the meaning of Article 104 of the Treaty."