ISSN 2250-3153

European Monetary Fund: Scope and Effectiveness

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Abstract- The European Monetary Fund will replace the European Financial Stability Facility. The EMF provides euro governments with financial means by selling Eurobonds in the capital markets and to bail-out packages for the PIIGS in EU. In "European Mechanism for Financial Stability" (EMFS), there are three possible mechanism:[i] International Monetary Fund (IMF) assistance but no conditionality [ii] Creation of the "European Monetary Fund" (EMF) [iii] Design of the "European Mechanism for Financial Stability", that could include the EMF. The mechanism should refer to an implementation in 2 stages. The financing mechanism of the EMF ties in with the budgetary discipline as laid down in Art.126 TFEU. The EU treaty provides for three different procedures to amend the Treaties.

Today the effective lending capacity of the EFSF is merely €250 billion, but it is scheduled to be increased to €440 billion. So EMF needs to primary and secondary markets for selling 5 year bonds. Even, total amount needed for a full, longer-term "bail out" of the entire periphery (Portugal, Ireland, Italy, Greece and Spain – or PIIGS) would be more than €2 trillion, or more than 20 percent of the euro zone's GDP. So, EFM would introduce VAT bonds which could increase more revenues of EU for bail out packages. The funding of the EMF would have to be even larger, if additional and potentially also larger countries like Spain or Italy were to be rescued. Thus, while the idea of an orderly default procedure is well worth pondering, it appears highly questionable that an EMF could shoulder this task. A better alternative would be to introduce such a mechanism in the IMF.

Index Terms- European Monetary Fund , Euro crisis, European monetary union

I. Introduction

Nine leaders of EEC at two days seminar in Bremen on 8 July 1978 took a major decision toward establishing greater currency stability in Europe creating 50,000 million dollar European Monetary Fund. Bundesbank opposed the idea and European Monetary System was set up in 1979.Ultimately idea was dropped. European Council of 21 July , 2011,effectively decided to transform the European Financial Stability Facility into European Monetary Fund by allowing it to engage in precautionary programmes and even to acquire debt at a discount on the secondary market. French President Nicolas Sarkozy declared proudly that euro area leaders have agreed to create the beginnings of a European Monetary Fund.

From 2013 a permanent European Financial Stability Mechanism, the European Monetary Fund will replace the European Financial Stability Facility. Besides this move joint Eurobond issue has been designed to guarantee the stability of the Euro Area. Setting up the EMF enables the Eurozone to avoid ad hoc interventions or calling the IMF.

The creation of the EMF would be concrete expression of the principle of solidarity enshrined in the Lisbon Treaty ,emphasizing in this case the particular responsibility of euro area member states to avoid creating difficulties for their partners. The EMF could be implemented within the framework of enhanced co-operation as laid down in Article 20 TEU and in Article 326 TFEU.

II. Provision of Law for EMF

On May 8, 2010, "the ECOFIN Council and the Euro group reached an agreement on a financial support package for Greece, conditional upon the adoption by the Greek Government of a range of economic and fiscal measures. The support package comprised €80 billion, in the form of centrally pooled bilateral loans from Greece's Euro area partners, and €30 billion, in the form of an IMF-sponsored loan. The European component of the support package was activated on May 9, 2010, with the signature of a Loan Facility Agreement. In May 2010, that package was inter alia backed by (1) a Council Regulation establishing a European Financial Stabilisation Mechanism (EFSM), to extend financial assistance to EU Member States in difficulty, in the form of interest-bearing loans or credit lines, and (2) an inter-governmental agreement among the Euro area Member States, complementing the EFSM with a European Financial Stability Facility (EFSF), in the form of a special purpose vehicle, to provide a further €440 billion in financial assistance." The EFSF issues bonds on the market, "using pro rata basis guarantees by all Euro area Member States who commit up front to their share of €440 billion, providing loans at interest rates determined on the basis of a pricing formula consistent with the IMF lending rates. Issues can be made via syndications but, also, auctions, private placements, new lines and tap issues. In the case of an issue by auction, the German Debt Management Office (Finanzagentur) is to act as issuance agent and be responsible for the placement, with the EFSF as the issuer."

To access the EFSF, Member States first need to agree on a "macroeconomic adjustment program with the Commission and the Euro group, in liaison with the ECB and, depending on the circumstances, also the IMF. The Euro group retains its decision-making responsibility, in particular with regard to the evaluation of conditionality and the authorization of disbursements. The EFSF was activated on January 25, 2011 with a landmark five-year bond auction worth €5 billion to raise funds for Ireland and was expected to provide an estimated €78 billion worth of aid to Portugal." As for the legality of the above mentioned rescue

package, and bearing in mind that financial support measures lie outside the scope of the exclusive competences of the EU, it is due to examine (1) the interpretation of Art.125 TFEU (the no-bail out clause), and (2) an understanding of the relationship between the no-bail out clause and Art. 122(2) TFEU (the financial solidarity clause), which was the legal basis for the adoption of the Council Regulation.

Gros and Mayer (2010) assume that the proposed EMF could be implemented within the framework of enhanced cooperation, a concept introduced into European law by the 2001 Treaty of Nice. In current Union law this enhanced cooperation is identified in Art.20 of the Treaty on European Union (TEU) and in Art.326 ff. of the Treaty on the Functioning of the EU (TFEU). Besides, according to Art. 326 TFEU enhanced cooperation has to comply with the Treaties and Union law. Thus, deviations from the primary law of the Union as laid down in the TEU and the TFEU would be illegal.

The detailed regulations of Art 119 ff. TFEU concerning the EEMU provide for intensified cooperation among a group of Member States within the field of monetary policy while excluding the other Member States. There would be no room for enhanced cooperation within the meaning of Art. 326 ff. TFEU, for it would not be permitted to deviate from those provisions of primary law. One option could be recourse to Art. 136 TFEU, originally introduced by the Lisbon Treaty.

The financing mechanism of the EMF suggested by Gros and Mayer(2010) ties in with the budgetary discipline as laid down in Art.126 TFEU. Paragraph 1 of Art.126 TFEU obliges the Member States to avoid excessive government deficits. The decisive criterion for a sustainable fiscal policy is compliance with the reference values for government debt and budgetary deficit. If Member States using the euro currency fail to comply with this budgetary discipline, then in accordance with paragraph 11 of Art. 126 TFEU, the Council can impose sanctions which, in the worst case, would be high fines. The EMF shall be financed through payments from those States that do not meet the reference values. In this respect, the question that arises here is whether those further consequences in addition to the sanctions of paragraph 11 of Art. 126 TFEU would be legally permissible. One argument against this is that paragraph 2 of Art. 126 TFEU does permit an exceeding of the reference values in certain cases. Details are laid down in Council Regulation 1467/97, which is an element of the Stability and Growth Pact. Actually, the sanctions of Art.126 TFEU are not tied to the mere exceeding of the reference values, but instead to the formal decision proclaiming the existence of an excessive deficit. Paragraph 1 of Art.140 TFEU proceeds in the same way. A Member State can introduce the euro only if there is no Council decision proclaiming the existence of an excessive deficit . Besides, the enumeration of sanctions due to a violation of the budgetary discipline in paragraph 11 of Art.126 TFEU is exhaustive. Thus, there may not be any justification for penalty payments in addition to the fines provided for due to a violation of the budgetary discipline. It therefore seems questionable whether Art. 4 of the Council Regulation (EC) No. 1084/2006 of 11 July 2006 establishing a Cohesion Fund, which allows for the suspension of the financing of projects by the Cohesion Fund if the Council has decided that an excessive public deficit exists, is compatible with Art. 126 TFEU. Even more so, Art. 126 TFEU does not permit payment obligations in terms of contributions to the EMF. The proposed financing mechanism could therefore not be realised without Treaty revision.

Paragraph 1 of Art.125 TFEU excludes the Union and the Member States from liability for the commitments of another Member State. This “no bail-out” clause is the key argument in the current debate on support for euro area members that encounter difficulties. Not only does the provision prohibit the assumption of a Member State’s debts, it also rules out EU liabilty for such commitments. This means that any measure equivalent to liability shall be prohibited.

A legal evaluation based only on Art. 125 TFEU would, however, be incomplete; one must also consider Art.122 TFEU. This provision calls not only for political but also for financial solidarity with Member States that are in severe difficulties. Paragraph 2 of Art.122 TFEU authorizes the Council to grant financial assistance from the Union to a Member State. This requires that the Member State in question is currently in, or is seriously threatened with, severe difficulties caused by natural disasters or exceptional occurrences beyond its control.When a Member State loses control over the situation because it can no longer help itself, the second requirement of paragraph 2 of Art. 122 TFEU is met. A third element is that the State has to be affected by, or threatened with, severe difficulties in the sense of serious damaging effects on the economy. There is definitely no doubt about that if there is an immediate threat of national bankruptcy. Given this background, it becomes evident that paragraph 2 of Art. 122 TFEU forms a far underestimated legal basis. On the other hand, Art. 125 TFEU prohibits an assumption of the commitments of a Member State.

The conflict between Art.125 and Art.122 TFEU cannot be solved by ignoring Art.122. If the requirements of both articles are met, it is not about suppression but about harmonisation.
The final version of the Treaty did not clearly decide for one or the other option but rather put them alongside each other. If one tries to harmonise both provisions, Art. 125 TFEU cannot completely preclude financial assistance. An enforceable claim to any such support by the Member State in question would compromise the exclusion of liability in Art.125 TFEU and must thus be rejected. Art. 125 TFEU excludes a bail-out by both the Union and the Member States while paragraph 2 of Art. 122 TFEU applies only to the Union; there is no provision for such an exception for the Member States. Thus, one can assume that the Contracting Parties wished to give the right to a deviation from Art.125 TFEU to the Union only.

For Member States outside the euro zone, Art. 143 TFEU permits mutual assistance with regard to difficulties in the balance of payments. In this context, the Council has based its Regulation (EC) No. 332/2002 of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States’ balances of payments on the “lacuna-filling competence“ of Art. 308 EC. It should thus be possible to adopt a regulation for the aforementioned operationalisation of financial assistance according to paragraph 2 of Art.122 TFEU on the basis of the successor provision, Art. 352 TFEU.

Besides, financing the Fund via contributions from those Member States that exceed the reference values for government debt and the budgetary deficit would not be compatible with Art.126 TFEU. Any other deviation from the procedures laid

down in the TFEU or even expulsion from the Monetary Union would also only be feasible by amending the Union Treaties.

Amendments of the Treaties-For the reasons explained above, certain aspects of the proposal could not be implemented under current Union law:

[i] The financing mechanism through payments from those Member States that do not meet the reference values for government debt and for the budgetary deficit would be incompatible with Art.126 TFEU;

[ii] Guarantees for public debts and payments to the creditors of the insolvent State within the orderly insolvency proceedings would be incompatible with Art 125 (1) TFEU;

[iii]Any other deviation from the procedures established in the TFEU (participation of the ECB, voting rights limitations that are not provided for) or even expulsion from the Monetary Union.

Therefore, it would be required to amend the Union Treaties.

The EU treaty provides for three different procedures to amend the Treaties:

[a] The ordinary revision procedure which may, inter alia, serve either to increase or reduce the competences of the Union on a proposal from a government, Parliament or the Commission to the Council which submits it to the European Council and notifies the national parliaments. After consulting Parliament and the Commission, the European Council decides by a simple majority in favor of examining the proposed amendments;

[b] The simplified revision procedure: this revision procedure concerns only provisions of Part III of the TFEU relating to the internal policies and action of the Union. The European Council, after consulting Parliament and the Commission, adopts an amending decision, which must be approved by the Member States. The decision may not extend the competences of the Union;

[c] The so-called bridging amendment: where the TFEU or Title V of the EU council may authorize the council to act by qualified majority, except in the area of defence.

Similarly, where adoption by the Council is provided via a special legislative procedure, the European Council may authorize adoption via the ordinary legislative procedure. These initiatives must act by unanimity after obtaining the consent of Parliament given by a majority of its components members. In this case, a key question is whether the conferral of additional policy areas from the Member States to the Union for the establishment of an EMF increases Union competences or not.

Art. 48 (6) TEU - the simplified revision procedure- would apply provided there is no increase in the competences conferred to the Union. The ordinary revision procedure – Art. 48 (3) TEU- would have to be applied given an increase in the Union competences. As a result, "a convention composed of representatives of the national Parliaments, of the Heads of State or Government of the Member States, of the European Parliament and of the Commission would have to be convened. However, the European Council could, after obtaining the consent of the European Parliament, decide to avoid a convention due to the limited extent of the proposed amendments and instead convene a conference of representatives of the governments of the Member States."

III. The Advantages and Scope of the EMF

We see two key advantages of EMF: [i] The funding of the EMF should give clear incentives for countries to keep their fiscal house in order at all times. [ii] The EMF could provide for an orderly sovereign bankruptcy procedure that minimises the disruption resulting from a default. In addition, the EMF could contribute decisively to the transparency of public finances because its intervention mechanism in the case of failure would penalise all derivatives and other transactions that had not been previously registered with a special registry of public debt, which the EMF would maintain. The creation of a European Monetary Fund should be seen as the best way to protect the interests of the (relatively) fiscally strong member countries. Without such an institution, a country like Germany would always find itself in a 'lose-lose' situation if a country like Greece is on the brink of collapse. If Germany agrees to a rescue package, it puts its public finances at risk. If it does not, its financial institutions would bear the brunt of the considerable losses that would arise from a disorderly failure and the ensuing contagion. Given the weak state of the German banking system, this would in the end also weaken German public finances.

The scope of the EMF is fourfold, namely;[i]The EMF provides euro governments with financial means by selling Eurobonds in the capital markets. These bonds are guaranteed by all euro countries to an unlimited extent. In addition, the EMF has full backing by the ECB (if necessary, the ECB buys Eurobonds from the EMF).

[ii]The EMF stabilizes Eurobond interest rates at a level slightly below the level of medium term
economic growth (in nominal terms). Investors hold the Eurobonds at the EMF, they are not tradable but can be liquidated at any time. In these two respects, the present proposal differs most from Eurobond concepts already put forward.

[iii] The EMF helps to restore sound public finances in euro countries according to a systemic approach and, hence, in close cooperation with the ECB, the European Commission and national governments. To this end, the EMF provides funds for the euro states according to clear criteria ("conditionality") which are not exclusively restrictive.

[iv]The EMF overcomes the split between euro countries caused by widening interest rate differentials and strengthens thereby the cohesion and credibility of the EMU and of the EU as a whole.

In "European Mechanism for Financial Stability" (EMFS), there are three possible mechanism:

[i] International Monetary Fund (IMF) assistance but no conditionality

[ii] Creation of the "European Monetary Fund" (EMF)

[iii] Design of the "European Mechanism for Financial Stability", that could include the EMF

The mechanism should refer to an implementation in 2 stages. During Stage I, any member country could call on the funds of the EMF up to the amount it has deposited in the past
(including interest). The government of the country in question could thus issue public debt with a guarantee of the EMF up to this amount. In Stage II , any drawing on the guarantee of the EMF above this amount would be possible only if the country agrees to a tailor-made adjustment plan supervised jointly by the Commission and the Euro group.

ISSN 2250-3153

This proposed mechanism intends to limit the moral hazard problem, because only countries that breach the Maastricht criteria have to contribute. The proposal of the contribution rates would be calculated on the following bases:

[a] 1% annually of the stock of 'excess debt', which is defined as the difference between the actual level of public debt (at the end of the previous year) and the Maastricht limit of 60% of GDP. For Greece with a debt-to-GDP ratio of 115%, this would imply a contribution to the EMF equal to 0.55%.

[b] 1% of the excessive deficit, i.e. the amount of the deficit for a given year that exceeds the Maastricht limit of 3% of GDP.

Countries with exceptionally strong public finances would not need to contribute because they would carry the burden. Their backing of the EMF (and the high rating of their bonds in the portfolio of the EMF) would be crucial if the EMF were called into action.

It is argued that taxing countries under fiscal stress to fund the EMF would only aggravate their problems and most of the contributions would materialize a long time before solvency problems become acute. An illustrative calculation estimates that the suggested funding mechanism, the EMF would have been able to accumulate 120 billion euro in reserves since the start of EMU. A pro argument for the EMF is that the EMF could provide for an orderly sovereign Bankruptcy procedure that minimizes the disruption resulting from a default. Some specialists suggested that such mechanism is only a redistribution of funds from a group of prudential country to non-prudential one. The technical issue is that the Treaties do not agree such an institution. Such mechanism has also to have consistency and interdependency with other related elements, as being part of financial system . Finally, "EMF per se is not a solution for another crisis but could be part of a prevention mechanism, if it implements adequate support for reformed policies by Member States intending to tackle the structural root of the crisis". It is hard to pronounce that the EMF would be implemented in reality, because despite pro and cons, the creation of the EMF remain, in final, a political decision.

IV. From EFSF to EMF

The present EFSF, whose lending capacity is effectively limited to about €250 billion, could not even cope with the commitments taken by the European Council now. The total required from European sources to finance Portugal, Ireland and Greece (PIGs) until 2014 would thus amount to approximately €420 billion. Today the effective lending capacity of the EFSF is merely €250 billion, but it is scheduled to be increased to €440 billion. This increase has been agreed at the political level, but it will be affective only after ratification by all 17 euro area parliaments. However, this effective capacity is subject to progressive erosion as more countries require support: in the EFSF setup, a country 'steps out' when it requires financial support itself and the contribution keys of the others (the remaining guarantors) increase. Moreover, the total amount of the guarantee commitment would decrease accordingly (Table 1).The predicted assistance until 2014 is also shown in Table-2.

Table-1: 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

Source-Gross and Giovannini,2011

Table-2:Hypothetical European financial assistance predicted until 2014 compared its resources(billion Euro)

Country	European financial assistance until2014	Total European financial assistance until 2014	Total EU resources: EFSF+EFSM +bilateral loan	Total EU resources: ExtendedEFSF+EFSM +bilateral loan
Greece	180	418	390	580
Ireland	110			
Portugal	128			

Source-Gross and Giovannini,2011

The European Council of July 21st opened the way for the EFSF to buy bonds in the secondary market; until now, the EFSF could merely, on an exceptional basis, intervene in the primary market in the context of a programme with strict conditionality. This 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 PIGs, an extended EFSF would have practically no resources left given that its lending capacity would be about €409 billion, not much more than the €370 million involved for the PIGs (counting also the first €80 billion for Greece). Just to have a yardstick, the results of the latest stress tests showed a sovereign direct long exposure of €150 billion of the banks analysed, so the available amount would only cover 25% of the exposure. Thus, the new powers will be dramatically limited not only by the natural political problem in reaching a consensus, but also by insufficient available resources.(Table-3)

Table-3:European bank exposure towards peripheral countries(only banks included in the 2011 stress test)

Country	Sovereign direct long exposure	Sovereign direct long exposure minus loans and	Net direct positions

		advances	
Greece	90.1	79.0	82.7
Ireland	19.3	16.5	15.8
Portugal	40.2	32.8	37.6
Total PIGS	149.6	128.3	136.1

Source-EBA,2011

The total amount needed from European sources for a full, longer-term "bail out" of the entire periphery (Portugal,Ireland,Greece and Spain – or PIGS) would thus be more than €2 trillion, or more than 20 percent of the euro zone's GDP (Table 4). For purposes of comparison, consider that the total EU-27 national contribution to the EU 2011 budget amounts to €108 billion, the ECB total assets to €1.9 thousand billion and its paid up capital to € 5 trillion.

Table-4:Scenarios for hypothetical full bail-out of the entire euro zone periphery(billions of euro)

	Total European contribution	Extended resources	Total EFSFwithout IMF
[1]Greece	80	30	
[2]Ireland	40	23	
[3]Portugal	52	26	
[4]Greece financing until 2014	71	33	
Total[1]-[4]	243	112	
[5]Ireland financing until2014	70	-	
[6]Portugal:financing until 2014	76	-	
Total[1]-[6]	389	112	
[7]Spain:long term financing plan	325	162	487
[8]Italy:long term financing plan	447	238	715
Total[1]-[8]	1190	913	1590
[9]Spain:long term financing plan	485	-	485
[10]Italy:long term financing plan	715	-	715
Total[1]-[10]	2390	913	2790
As % of Eurozone GDP	24		28
As % of peripheral Eurozone public debt	76		89
As % of Eurozone bank assets	7		9

Source-Gross and Giovannini,2011

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 stabilize 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.

[i] 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 (Art. 2(7) of the EFSF Framework Agreement).

[ii] 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.

Table-5: Increasing weights of Germany and France (%)

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-Gross and Giovannini, 2011

Table-6: Progressive erosion of the EU effective lending capacity(billions of euro)

Step out sequence	EFSF	Extended EFSF
Starting point	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-Gross and Giovannini, 2011

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. (Table-7)At the moment France provides 22 % of EFSF's total guarantees, around €90 billion, destined to become €158 billion 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.

Table-7: Actual ratings of Eurozone 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.

Thus, a two-pillar structure to finance the embryo of a European Monetary Fund as it exists in the form of the EFSF today was proposed. The 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:

[a] 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.

[b] 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 (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 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 €700 billion annually (about 7 % of GDP), is already shown in CESifo DICE Report 3/2011 .

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

[i]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.

[ii]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% of GDP, or about €13 billion annually which is greater 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 % of GDP whereas interest payments on government bonds are less than 3% 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:

[i] It would limit the risk for the fiscally virtuous countries as argued above. Given that the maximum at stake is VAT revenues.

[ii] 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 harmonization of VAT revenues (around 6–7 % of GDP).

[iii]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.

[iv]VAT revenues could be "unionised" for programme countries, providing a further guarantee for the creditors.

Table-8:Private consumption and VAT (% of GDP and tax rates)

	VAT/GDP	Private consump-tion/GDP	Effective VAT rate on consump-tion (= VAT revenues/con-sumption)	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).

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 8 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 (Table- 9 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 PIGs, an extended EFSF would have practically no resources left, given that its lending capacity would be about € 409 billion, not much more than the €390 required for the PIIGs.

Smaller secondary market intervention in case of limited liquidity gaps could be funded with EFSF's resources. 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 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.

The 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.

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 generalized 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.

**Table-9: 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

V. Concluding Remarks

The basic idea behind an EMF appears worth considering at first glance. This institutional innovation is intended to fill the above-mentioned gap in EMU's governance framework, because it would be able to deal with impending sovereign defaults by providing support packages, while at the same time imposing reform conditions in order to correct fiscal imbalances. However, for several reasons this approach does not appear commendable.

First and foremost, the EMF would face the same problems of time-inconsistency of its conditionality that would generate the same lack of credibility as the instruments analysed above. Once again EMU countries would – probably in vain – try to enforce strict reform conditions in the face of foreseeable strong protests against the EMF and against fiscally austere EMU countries. Moreover, it is unlikely that from the outset reform conditions will be sufficiently strict, as other countries which could come under the auspices of the EMF would be represented on the board of the EMF. Taken together, both arguments suggest that the EMF might not be sufficiently strong to enforce the required fiscal discipline which its proponents (and the German government) intend it to do. Thus, with the availability of a rescue fund which lacks credible enforcement tools, the problem of moral hazard might become even more severe than without an EMF. The EMF might even turn into a threat for European integration.

Fiscally sound northern European countries –particularly Germany – would fear being indirectly forced to bail out fiscally profligate EMU countries. At first glance, this fear seems to be mitigated by the fact that the EMF should be partly financed by countries with excess debts and deficits. But northern European countries would have to participate in the initial funding and would eventually be liable for the loans which the EMF most likely would have to take out in large amounts in order to obtain sufficient resources for crisis resolutions.

Thus, because northern European countries would feel exploited, voters in these parts of the euro zone might turn against EMU. In the end, it is imaginable that northern European countries could even leave the euro zone – in order to form a new currency union.

In addition, there are severe legal and technical obstacles which speak against the creation of an EMF. Most likely, the EMF would violate the no-bailout clause, so that a revision of the EU Treaty would be required – which could easily take several years to materialise. Moreover, it appears excessively costly to build up a competing – and thus possibly redundant – institution to the IMF, because a costly new bureaucracy and immense finances would be needed. The EMF would not be redundant if – and this leads to a very reasonable aspect of the proposal by Gros and Mayer – the suggested mechanism for an orderly sovereign default was implemented. In order to avoid severe disruptions in financial markets, the EMF would buy Greek government bonds at a discount. This would limit losses for the debt holders and probably save most European banks from sliding into another crisis. At the same time the moral hazard on the side of the creditors would be limited, as they would be prevented from pocketing high interest payments on Greek treasuries without facing a real default risk because they expected a generous financial rescue package by EMU countries.

However, the financial means required to buy a large amount of Greek government debt (which amounts to around €300 billion in total) are immense. The funding of the EMF would have to be even larger, if additional and potentially also larger countries like Spain or Italy were to be rescued. Thus, while the idea of an orderly default procedure is well worth pondering, it appears highly questionable that an EMF could shoulder this task. A better alternative would be to introduce such a mechanism in the IMF.

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