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The Eurozone decisions: a step towards a European lender of last resort, but others must follow

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Abstract

The decisions taken by the recent meeting of the Heads of State and Government - held in Brussels on 21 July 2011- strengthen the European Financial Stability Facility (EFSF) and constitute a first step towards a European lender of last resort. But other steps will have to follow to make this credible

Key-words:

European Financial Stability Facility (EFSF), Euro, Eurozone



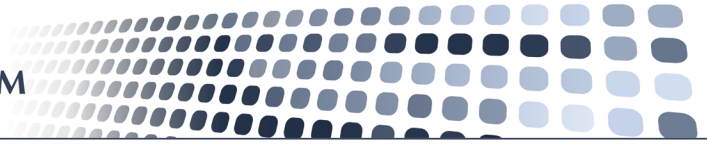
1. Introduction

In the meeting of the Heads of State and Government in the Euro-zone, held in Brussels on 21 July 2011, the loan available from the EFSF^I was considerably boosted-up to 440 billion Euros – and, above all, the possibility was provided to buy the bonds of any Euro-zone country on the secondary market (as well as substantially improving the terms under which loans are granted and extending their maturity dates).

These decisions are leading to a radical transformation of the EFSF which, from being purely a means for issuing loans to avoid defaults by countries struggling with a sovereign debt crisis, is now tending to acquire the characteristics of a lender of last resort, being able to buy public securities also on the secondary market in order to support their value and reduce the debt burden (the securities are devalued and thus bought at a lower price than their issue value. As a consequence, vulnerable countries become debtors to the EFSF for an amount lower than the face value).

A further step will be taken, in the institutional area, with the transformation of the EFSF into the European Stability Mechanism (ESM), which is an intergovernmental institution created by a Treaty signed by the Euro-zone countries. The ESM will be headed by a Board of Governors consisting of the various Ministers of Finance and will pass decisions by a qualified majority. Only the granting and the terms of a loan to an economically troubled country and the variation in the size and composition of the instruments available to the ESM will have to be decided by means of mutual agreement, which means that such a decision requires unanimous consent from all countries voting and that, therefore, an abstention by a country will not nullify the decision.

Many limitations still remain in this new institution since every decision about granting funds depends on the unanimous consent of the governments participating in the decision. Furthermore, the loans are granted at high rates of interest (the cost of the loan plus 200 basis points) and are conditional upon a fiscal correction that will have a high social cost and is also unrealistic when there is no Europe-wide policy to assure a return to growth. But, as long as this evolution is announced to the market as a step towards creating a fully federal Fiscal Union^{II}, founding a European Treasury responsible for defining and



implementing general lines of economic policy and which can rely on a federal budget with its own resources and the possibility to issue Eurobonds to finance a European plan for sustainable growth, it will be possible to immediately guarantee the financial stability of the weaker countries and, as a result, narrow the spread with the bonds from stronger Eurozone countries, as happened in the 1990s with the reduction of interest rates for those countries aiming to meet the terms for joining the single currency.

^I The European Financial Stability Facility is a company that issues bonds and other debt instruments on the market, guaranteed by member states, in order to offer financial support to member countries having difficulty with issuing new emissions. Such loans are dependent on the receiving countries implementing austerity measures

^{II} For a more in-depth discussion of a plan for achieving by successive steps a fully-fledged federal Fiscal Union, see: Majocchi, 2011, *Towards a European Federal Fiscal Union*, available at <http://www.on-federalism.eu/index.php/component/content/article/96-towards-a-european-federal-fiscal-union>