New EU Stability Mechanism Treaty on strengthening fiscal discipline and convergence

EU leader Member States agreed on a new Treaty on Stability, Coordination and Convergence in the Economic and Monetary Union. The European Stability Mechanism (ESM) Treaty was signed by euro area Member States on 2 February 2012 and ratification is pending by the 17 euro area Member States. The target date of its operation is July 2012, a year earlier than expected.

Objectives for the Eurozone

The Treaty aims at strengthening fiscal discipline and introducing more automatic sanctions and stricter surveillance with the euro area through new budgetary rules and procedures. Its purpose is to provide financial assistance to its Members, experiencing or being seriously threatened by severe financing problems, providing a stabilisation in the euro area as a whole.

The specific updated Treaty replaces its original version which was signed on 11 July 2011. The main changes made by the updated treaty is the new financing tools, more flexible pricing, link with fiscal compact, new emergency decision-making procedure, alignment with International Monetary Fund (IMF) practice, as regards private sector involvement and timing of capital contribution.

Function and procedures

The Member States parties to the new treaty will report their public debt issuance plans to the European Commission and to the Council. They will coordinate among themselves and with the EU institutions in advance all of the major economic reforms that they plan to undertake.

The euro area member states will hold meetings at least twice a year and will elect the president of the euro area summit by a simple majority of votes. Reports of the meetings will be presented to the European Parliament (EP). The President of the EP may be invited to be heard at the Euro Summit.

This permanent crisis mechanism will contribute to raising confidence and ensuring solidarity and financial stability in the euro area. It creates a permanent firewall with a broad range of tools and a strong financial basis, to safeguard financial stability.

As a permanent mechanism, the ESM will take over the tasks currently fulfilled by the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM).

It will also have a very close cooperation with the IMF in providing stability support, both at technical and financial level.

The ESM will be an international financial institution, based in Luxembourg and having the option of establishing a liaison office in Brussels, according to Article 3. It is founded by euro area member states, with an initial maximum lending volume of €500 billon, to be achieved by €700 billion of subscribed capital (€80bn in paid-in shares and €620 billion in callable shares).

It will also provide precautionary financial assistance, besides loans to beneficiaries, according to Article 14. Loans will also be given to Member States for recapitalisations of financial institutions (Article 15). The decision of the Board of Governors to decide to grant financial assistance in the form of a loan to an ESM Member, would be in accordance with Article 12 as laid down in article 16.

Bonds of beneficiary Member States on primary and secondary markets could also be purchased by the ESM whereas in the previous treaty as only provided for ‘as an exception’ (Article 17) and 18.

Moreover, it also provides for precautionary financial assistance ‘in the form of a precautionary conditioned credit line or in the form of an enhanced conditions credit line’.

The updated Treaty no longer predefines margins on its loans. Instead, the price should be equivalent to the lending rates of the EU’s balance of payments facility, whilst covering financing and operating costs and including an appropriate margin according to Article 20.

In regards to the investment policy, the managing director shall implement a prudent investment policy for the ESM, so as to ensure its highest creditworthiness. The ESM shall be entitled to use part of the return on its investment portfolio to cover its operating and administrative costs (Article 22).

The new fiscal Treaty requires national budgets to be in balance or in a surplus. This criterion would only be met if the annual deficit of the Member State does not exceed 0.5% of nominal GDP. Deviation from the rule would trigger an automatic correction mechanism.

<u>Obligation for transposition into national legislation</u>

This EU rule must be incorporated into the national legislation of the Member State to transpose this EU rule into national legislation within the deadline imposed, the EU Court of Justice will have jurisdiction to take a decision on the matter.

The Court's decision will be binding, and, if not implemented, can be followed up with a penalty of up to 0.1% of GDP. This amount will be payable to the European Stability Mechanism if the country's currency is the euro, otherwise to the general budget of the EU.

The excessive deficit procedure will also be more automatic. Euro area Member States commit to support the Commission's proposals except when a qualified majority of them would be against the decision. An emergency procedure exists whereby a decision to grant financial assistance can be taken by qualified majority of 85% of votes cast. This procedure can be used where the Commission and the European Central Bank both conclude that a failure to urgently adopt a decision to grant or implement financial assistance would threaten the economic and financial sustainability of the euro area.

<u>Financial issues for the Republic of Cyprus</u>

The contribution key of the ESM for the Republic of Cyprus amounts to 0,1962% and is the lowest percentage after Malta and the Republic of Estonia. The highest contribution key of the ESM belongs to the Federal Republic of Germany reaching 27,14,64%. Regarding the subscriptions to the authorised capital stock, the number of shares which correspond to the Republic of Cyprus is 13734 and they are translated in a capital subscription of 1 billion 373,4 million euro out of a total of 7 hundred billion euro for the seventeen participating in the ESM Member States (Article 8).

<u>Obligations of the contracting parties</u>

In regards to the contracting parties, they should be conscious on their obligations concerning the economic policies, maintaining sound and sustainable public finances while ensuring that their deficits do not exceed 3% of their gross domestic product at market prices.

The Board of Governors may call in authorised unpaid capital at any time and set an appropriate period of time for its payment by the ESM Members (Article 9).

The Contracting parties should take a note of the Commission's intention to present further legislative proposals for the euro area, especially those parties that are facing serious economic difficulties, on common provisions for monitoring and assessing draft budgetary plans and also on the correction of excessive deficit of the Member States. To this end, the Member States should facilitate the adoption on measures under the excessive deficit procedure while not underestimating the specific role of the social partnership and enhanced cooperation on the functioning of the European Union.

ESM members should ensure the required amount of paid-in capital gradually, within the first five years from the ESM's creation. This process is enabled to be accelerated by article 41(3).
The temporary correction included in this initial contribution key shall apply for a period of twelve years after the date of adoption of the euro by the ESM Member concerned (Article 42(1)).

If a new ESM Member's gross domestic product (GDP) per capita at market prices in euro in the year immediately preceding its accession to the ESM is less than 75 % of the European Union average GDP per capita at market prices, then its contribution key for subscribing to ESM authorised capital stock, determined in accordance with Article 10, shall benefit from a temporary correction and equal the sum of: (a) 25 % of the percentage share in the ECB capital of the national central bank of that ESM Member, determined in accordance with Article 29 of the ESCB Statute; and (b) 75 % of that ESM Member's percentage share in the gross national income (GNI) at market prices in euro of the euro area in the year immediately preceding its accession to the ESM (Article 42(2)).

Conclusion

All these steps for the implementation of an overall strategy ready to fight the crisis, are considered as a major step forward towards a closer fiscal and economic integration as well as a stronger governance initiative within the euro area, enhancing growth, sustainability and stability of the Eurozone.

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