EUROPEAN MONETARY FUND - BETWEEN ILLUSION AND FUTURE INSTRUMENT FOR EUROPEAN FINANCIAL STABILITY

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The finance crises that culminate with the Greece situation shows that majority of European countries are facing balance-of-payments difficulties and it is clear that actual mechanism couldn't face the situation. This paper wants to highlight some of the proposals related to the development mechanisms, such the creation of the European Monetary Fund or the design of the "European Mechanism for Financial Stability" (EMFS), which could include the EMF, showing also the actual mechanism of financing through International Monetary Fund (IMF).Some pro and counter arguments are furthermore taken into discussion.

Keywords: European Monetary Fund - EMF, International Monetary Fund – IMF, European Union – EU, sovereign defaults, financing mechanism, financial system.

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Actual stage of financial crises – foundation and argument for construction of the European Monetary Fund (EMF)

It is considered that actual financial crises have entered in a second phase, regarding the public debt crises, facing the threat of sovereign default. The case of Greece is frequently taken into discussion, but other countries are also confronting with large public debts. As Eurostat shows in its latest statistics[476], in 2009, the government deficit and government debt of both the euro area (EA16) and the EU27 increased compared with 2008, while GDP fell. In the euro area the government deficit to GDP ratio increased from 2.0% in 20083 to 6.3% in 2009, and in the EU27 from 2.3% to 6.8%. In the euro area the government debt to GDP ratio increased from 69.4% at the end of 2008 to 78.7% at the end of 2009, and in the EU27 from 61.6% to 73.6%.

In 2009 the largest government deficits in percentage of GDP were recorded as follows: Ireland (-14.3%), Greece (-13.6%) the United Kingdom (-11.5%), Spain (-11.2%), Portugal (-9.4%), Latvia (-9.0%), Lithuania (-8.9%), Romania (-8.3%), France (-7.5%) and Poland (-7.1%). No Member State registered a government surplus in 2009. The lowest deficits were recorded in Sweden (-0.5%), Luxembourg (-0.7%) and Estonia (-1.7%). The data suggests a worsening in government balance relative to GDP in 2009 compared with 2008 in twenty-five states, and only in two (Estonia and Malta) an improvement.

At the end of 2009, the lowest ratios of government debt to GDP were recorded in Estonia (7.2%), Luxembourg (14.5%), Bulgaria (14.8%), Romania (23.7%), Lithuania (29.3%) and the Czech Republic (35.4%). Twelve Member States had government debt ratios higher than 60% of GDP in 2009: Italy (115.8%), Greece (115.1%), Belgium (96.7%), Hungary (78.3%), France (77.6%), Portugal (76.8%), Germany (73.2%), Malta (69.1%), the United Kingdom (68.1%), Austria (66.5%), Ireland (64.0%) and the Netherlands (60.9%).

The economic and financial evolution in EU16 and EU27 related to government activity evaluated in percentage of GDP for the last 4 years can be summarized in the table below (see Table 1):

[476] http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22042010-BP/EN/2-22042010-BP-EN.PDF, p.1-2, accessed on 23rd of April, 2010.

Table 1 – Government deficits (percentage of GDP) in 2006-2009

	2006	2007	2008	2009
Euro area (EA16)				
Government expenditure	46.7	46.0	46.8	50.7
Government revenue	45.3	45.4	44.9	44.4
Government debt	68.3	66.0	69.4	78.7
EU27				
Government expenditure	46.3	45.7	46.9	50.7
Government revenue	44.9	44.9	44.6	44.0
Government debt	61.4	58.8	61.6	73.6

Source: Eurostat, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22042010-BP/EN/2-22042010-BP-EN.PDF

Euro area annual inflation was 1.4% in March 2010, up from 0.9% in February, compared with the value recorded a year earlier the rate - 0.6%. The lowest 12-month averages up to March 2010 were registered in Ireland (-2.3%), Portugal (-0.8%) and Estonia (-0.7%), and the highest in Romania (5.0%), Hungary (4.8%) and Poland (3.9%)[477].As shown above, macroeconomic indicators worsened in the last 2 years, suggesting the profound implication of financial crises in majority of the European States. These data indicates that actual European Union economic and financial mechanisms are still inadequate to face financial crises. As some authors suggested[478], related to monetary policy of European Central Bank, an imperfect functioning may cause disproportionate inflation, while wrong fiscal policy decisions, such the excessive deficit procedure may induce a threat of sovereign default. It appears that Greece is the weakest, given its high public debt (about 120% of GDP) compounded by a government budget deficit of almost 13% of GDP, a massive external deficit of 11% of GDP, and the loss of credibility from its repeated cheating on budget reports.

Solutions for debt crisis and strengthening economic policy coordination in the Euro-zone

In actual case, it is suggested that given the intense pressure from financial markets, is likely that a tough fiscal adjustment agenda (or rather the promise that one will be forthcoming) might not be enough to avoid a 'sudden stop' of necessary external funding of the public sector. When this happens the EU will no longer be able to fudge the question of whether (and in what form) it can provide public financial support to one of its members[479].

Some opinions propose that the crisis in Greece calls for standard remedies and the solution would be to bring in the IMF. A stand-by agreement involving conditional lending would provide financial assistance and fiscal adjustment measures which should restore confidence. However, Euro-zone and EU authorities appear to be against this[480].

Another proposal came from The European Commission that appear to support the creating a European Monetary Fund (EMF) to help Euro-zone countries facing balance-of-payments difficulties. Officials of the EU agreed that "The Commission is ready to propose such a

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[477] http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-16042010-BP/EN/2-16042010-BP-EN.PDF. p. 1, accessed on 23rd of April, 2010.

[478] see Varela D. – *Guvernarea Uniunii Europene,* Institutul European, Iaşi, 2008, p. 128.

[479] Gros D., Mayer T. - *Towards a Euro(pean) Monetary Fund, http://www.dbresearch.com/ PROD /DBR_INTERNET_EN-PROD/PROD0000000000253712.pdf ,* p. 1.

[480] see Pisani-Ferry J., Sapir - *The best course for Greece is to call in the Fund,* 2010, *http://www.ft.com/cms/s/0/01554c86-0f69-11df-a450-00144feabdc0.html*

European instrument for assistance, which would require the support of all euro area member states"[481]. Germany's finance minister, said in an interview that he would present proposals for a European monetary fund soon. He said that the Euro-zone needed an institution "for its internal stability". This new body would not compete with the International Monetary Fund, he said, but would benefit from the IMF's experience and have comparable powers to the fund, he said. He said that accepting financial assistance from the IMF would be an admission that the Euro-zone countries were unable to solve their problems by themselves[482].
An additional proposal came from the PES, together with the S&D Group at the European Parliament (on 2nd of March, 2010), suggesting a plan that implies a three step strategy to address the sovereign debt crisis and to strengthen economic policy coordination in the Euro-zone:
1. the Greek sovereign debt crisis must be solved without delay – it is necessary to establish an emergency credit facility mechanism at the European level, allowing Greece to re-finance its economy at a fair price;
2. the emergency mechanism must be converted, over the medium-term, into a permanent feature of the Euro-zone – creation of a crisis-management mechanism, the "European Mechanism for Financial Stability" (EMFS);
3.the development of further EMFS into a long-term framework for strengthened economic governance in the Euro-zone[483].
As seen before, there are three possible mechanism:
- *International Monetary Fund (IMF) assistance*
- *creation of the "European Monetary Fund" (EMF)*
- *design of the "European Mechanism for Financial Stability", that could include the EMF (not discussed in this paper below).*
The financing through IMF and characteristics of the "European Monetary Fund" (EMF) are discussed below.

Financing Mechanism through IMF lending

Upon request by a member country, an IMF loan is usually provided under an "arrangement," which may, when appropriate, stipulate specific policies and measures a country has agreed to implement to resolve its balance of payments problem. The economic program underlying an arrangement is formulated by the country in consultation with the IMF and is presented to the Fund's Executive Board in a "Letter of Intent." Once an arrangement is approved by the Board, the loan is usually released in phased installments as the program is implemented[484].

IMF Facilities

Over the years, the IMF has developed various loan instruments, or "facilities," that are tailored to address the specific circumstances of its diverse membership[485]. Low-income countries may borrow on concessional terms through the Extended Credit Facility (ECF), the Standby Credit Facility (SCF) and the Rapid Credit Facility (RCF). Non-concessional loans are provided mainly through Stand-By Arrangements (SBA), the Flexible Credit Line (FCL), and the Extended Fund Facility (which is useful primarily for longer-term needs). The IMF also provides emergency assistance to support recovery from natural disasters and conflicts. All non-concessional facilities

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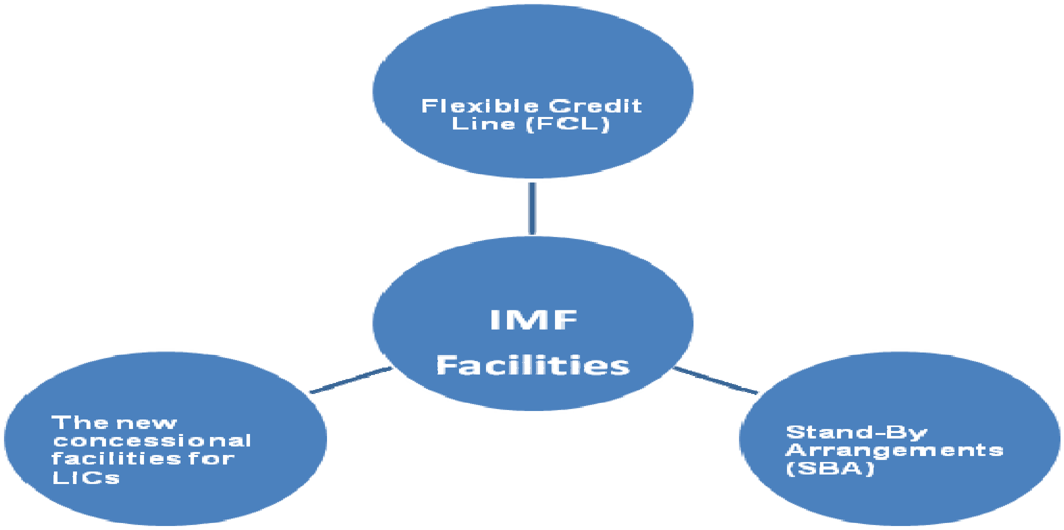
[481] Brunsden, J., Taylor, S. - *Commission backs European Monetary Fund, 2010* http://www.europeanvoice.com/article/2010/03/commission-backs-european-monetary-fund-/67349.aspx
[482] *ibid.*
[483] see http://www.pes.org/en/system/files/ Adopted_PES_European_Mechanism_for_Financial_ Stability 250310_EN.pdf
[484] see*** - IMF Lending, IMF Factsheet, p.1- 4, http://www.imf.org/external/np/exr/facts/howlend.htm.
[485] for information related to IMF financing see Voinea, Gh. – *Mecanisme şi tehnici valutare internaţionale*, Editura Sedcom Libris, Iaşi, 2004, p. 239-250

are subject to the IMF's market-related interest rate, known as the "rate of charge," and large loans (above certain limits) carry a surcharge. The IMF facilities can be grouped as shown in Figure1.

Figure 1 – IMF Facilities



The new concessional facilities for LICs were established in January 2010 under the Poverty Reduction and Growth Trust (PRGT) as part of a broader reform to make the Fund's financial support more flexible and better tailored to the diverse needs of LICs. Access limits and norms have been approximately doubled compared to pre-crisis levels. Financing terms have been made more concessional, and the interest rate is reviewed every two years. All facilities support country-owned programs aimed at achieving a sustainable macroeconomic position consistent with strong and durable poverty reduction and growth. Most important instruments are presented below.

The Extended Credit Facility (ECF) succeeds the Poverty Reduction and Growth Facility (PRGF) as the Fund's main tool for providing medium-term support to LICs with protracted balance of payments problems. Financing under the ECF currently carries a zero interest rate, with a grace period of 5 ½ years, and a final maturity of 10 years.

The Standby Credit Facility (SCF) provides financial assistance to LICs with short-term balance of payments needs. The SCF replaces the High-Access Component of the Exogenous Shocks Facility (ESF), and can be used in a wide range of circumstances, including on a precautionary basis. Financing under the SCF currently carries a zero interest rate, with a grace period of 4 years, and a final maturity of 8 years.

The Rapid Credit Facility (RCF) provides rapid financial assistance with limited conditionality to LICs facing an urgent balance of payments need. The RCF streamlines the Fund's emergency assistance for LICs, and can be used flexibly in a wide range of circumstances. Financing under the RCF currently carries a zero interest rate, has a grace period of 5% years, and a final maturity of 10 years.

Stand-By Arrangements (SBA). The bulk of Fund assistance to middle-income countries is provided through SBAs. The SBA is designed to help countries address short-term balance of payments problems. Program targets are designed to address these problems and Fund disbursements are made conditional on achieving these targets ('conditionality'). The length of a SBA is typically 12-24 months, and repayment is due within 3%-5 years of disbursement. SBAs may be provided on a precautionary basis—where countries choose not to draw upon approved amounts but retain the option to do so if conditions deteriorate— both within the normal access limits and in cases of exceptional access. The SBA provides for flexibility with respect to phasing, with front-loaded access where appropriate.

Flexible Credit Line (FCL). The FCL is for countries with very strong fundamentals, policies, and track records of policy implementation and is particularly useful for crisis prevention purposes. FCL arrangements are approved for countries meeting pre-set qualification criteria. The length of the FCL is 6 months or 1 year (with a mid-term review) and the repayment period the same as for the SBA.

Financing Mechanism through 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 Eurogroup.

This proposed mechanism[486] intends to limit the moral hazard[487] problem, because only countries that breach the Maastricht criteria have to contribute. The authors propose that contribution rates would be calculated on the following bases:

- 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%.
- 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.

Authors 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 – enough probably to finance the rescue of any of the small-to-medium-sized euro area member states[488].

There are some issues to be discussed related to this proposal. A pro argument for the EMF is one suggested by the authors themselves - 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. There is also a technical issue – 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[489]. 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

[486] according to Gros D., Mayer T. – *op.cit.,* p.5

[487] see also Gros D., Mayer T. – *How to Deal with the Threat of Sovereign Default in Europe: Towards a Euro(pean) Monetary Fund,* 2010, http://www.ceps.eu/system/files/article/2010/04/064-095-Forum.pdf

[488] according to Gros D., Mayer T. – op.cit., p. 6

[489] see Fîrțescu, B. – *Sistemul financiar al României,* Editura Universității "Al. I. Cuza", Iași, 2010

reformed policies by Member States intending to tackle the structural root of the crisis"[490].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.

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