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April 6th 2022

The European Stability Mechanism is a dead letter with inadequate firepower

The European Stability Mechanism (ESM) is the main Eurozone bailout fund should further members be unable to access capital markets directly: the ESM would finance the member state, as they have done for their five existing debtors, who are Spain, Greece, Portugal, Ireland and Cyprus.[1]

The problem is that the ESM does not have the headroom to deal with a new Eurozone debt crisis if a major member needed to borrow from it.

Current ESM volumes

Current loan outstandings to ESM debtor members and the start of their run-off are:

- Spain €24 billion running off from 2022
- Greece €131 billion running off from 2022
- Portugal €25 billion running off from 2025
- Ireland €18 billion running off from 2029
- Cyprus €6 billion running off from 2025

These outstandings total €204 billion, as against a maximum lending cap of €500 billion, ostensibly leaving headroom at present of €296 billion for new loans. The ESM balance sheet totals €829 billion, also inferring ample resources. However the balance sheet is inflated by €624 billion.[2] The ESM has subscribed capital of €705 billion, subscribed by the Eurozone member states on a several-but-not-joint basis.[3] €81 billion of this is paid in. The remaining €624 billion is a reserve fund to be called up if one or more of the debtors default, and the ESM is unable to repay the bonds it has issued in order to raise funds to lend.

Faulty ESM accounting for and presentation of its assets

The ESM balance sheet wrongly carries the full €705 billion of capital on the liabilities side, and the unpaid portion of €624 billion on the asset side, when it is not an asset but a contingent claim. It has no place on a balance sheet. The European Investment Bank (EIB), whose capital structure is similar, correctly nets its unpaid capital of €227 billion off against its subscribed capital of €247 billion on the liabilities side of its balance sheet without claiming the existence of any related asset.[4] The ESM balance sheet footing ought instead to be lower by this €624 billion and be on a level with the outstandings to the debtor members: the ESM has no other assets of any substance.

[1] www.esm.europa.eu, accessed on 02 April 2022
[2] ESM 2020 Annual Report p. 68
[3] Each subscriber is responsible only for their own allocated portion. They do not have to pay more if other subscribers fail to pay in their respective allocated portion
[4] EIB 2020 Financial Report p. 39

There is a second significant accounting legerdemain in that the ESM balance sheet carries €58 billion under the heading of 'Cash in hand, with central banks and post office banks' and a further €11 billion under the heading of 'Loans and advances to credit institutions'.

These treatments infer that the captioned assets are separate from the bailout programmes, that they are of higher quality and liquidity than bailout programme assets, and that they are free resources available to be mobilized for new bailout programmes.

In reality they are part and parcel of the existing bailout programmes for the five debtor members and are of the same quality and liquidity as 'Loans and advances to euro area member states' (€90 billion) and 'Debt securities' (€44 billion).

These four balance sheet positions totalled €203 billion and equated to the outstandings as they were at the end of 2020.[5] The ESM has no banking assets outside of its bailout programmes, contrary to what the presentation of its accounts infers.

ESM liabilities and capital structure

The ESM had €118 billion of bonds in issue at the end of 2020.[6] That amount, together with the €81 billion of paid-in capital, formed the bedrock of the refinancing for its loans: €199 billion of the funding for its €203 billion of bailout programme assets at the time. There were €4-5 billion of miscellaneous liabilities to make up the balance sheet footing as it should have been stated.

The ESM's capital is structured similarly to the EIB's in that there is recourse to members for extra money if a debtor defaults, but there are meaningful differences: only the 19 Eurozone countries are ESM members, the ESM's assets are concentrated into five ESM members, and these members have been in or near default in the recent past.

This is one reason why the subscribed capital is set at an impressive 150% of the lending cap, but there is another: a debtor member would be unlikely to be able to meet a capital call. The ESM loan book cannot therefore exceed the paid-in capital plus the subscribed-but-not-paid capital of non-debtor members.

This severely limits the ESM's actual firepower compared to the resources inferred by its 2020 balance sheet footing.

Firepower calculation must deduct back the unpaid capital of debtor members

Although the reserve fund is €624 billion on a gross basis now, one has to deduct back from that figure the unpaid subscriptions of the debtor members. After all, it is a future default from one of these debtors that would be the cause of a call on the reserve fund.

The subscribed-but-not-paid capital contributions of ESM debtors are:
Spain: €73 billion
Greece: €17 billion
Portugal: €15 billion
Ireland: €10 billion
Cyprus: €1 billion

[5] ESM 2020 Annual Report p. 68
[6] ESM 2020 Annual Report p. 68

One might argue that it is unfair to discount the entire subscribed-but-not-paid capital of €73 billion of Spain, when they have only borrowed €24 billion, but that is the logic of the set-up, and it threatens to rebound on the European authorities.

The amount to be deducted back from the reserve fund is €116 billion, which reduces it to the €508 billion that can be called in from non-debtor members. Together with the paid-in capital of €81 billion, the ESM has reference resources of €589 billion behind its lending cap of €500 billion.

Inadequate firepower to bail out an Italy or a France

The lending headroom now, at €296 billion, is not large compared to these two members' 'General government gross debt' at the end of 2020: Italy's at €2,573 billion and France's at €2,649 billion.[7] Nor does the ESM have major run-offs in the near future that will create re-drawable capacity.

The subscribed-but-not-paid capital of the new debtor member(s) would have to be deducted back from the current reference resources to determine the actual headroom for new ESM lending. Italy and France, being large members, account for significant shares of the ESM's subscribed-but-not-paid capital.

In € billions	**Italy becomes a debtor**	**France becomes a debtor**	**Italy and France become debtors**
ESM reference resources now	589	589	589
ESM headroom now	296	296	296
Debtor subscribed-but-not-paid capital	111	126	237
New references resources[8]	478	463	352
Current outstandings	204	204	204
Revised, lower headroom[9]	274	259	148
Revised headroom as a percentage of debtor GGGD[10]	10.65%	9.78%	2.83%

The revised headroom does not measure up to the challenge. A need for either Italy or France to tap the ESM would increase the outstandings markedly if the ESM's intervention were to be material in terms of the size of Italy's or France's debts, but the structure of the ESM inhibits its intervening in new cases of a material scale. It could not take on the level of share of the GGGD of these members that it owns of Greece's (38%) or of Cyprus' (25%).[11]

The ostensible 'over-capitalization' of the ESM, achieved by having subscribed capital of €705 billion and a lending cap of €500 billion, only works so long as the larger members do not become debtors.

The ESM is a dead letter as a lifeboat for any large Eurozone member state.

BL/6.4.22

[7] https://ec.europa.eu/eurostat/databrowser/view/sdg_17_40/default/table?lang=en, accessed on 1 April 2022
[8] Reference resources now less Debtor subscribed-but-not-paid capital
[9] New references resources less Current outstandings
[10] 2020 'General government gross debt'
[11] €131 billion out of Eurostat's €341 billion for Greece and €6 billion out of €24 billion for Cyprus