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**Working Paper**

## The evolution of the European Stability Mechanism: Lessons for Asian integration

ADB Working Paper Series, No. 1173

**Provided in Cooperation with:**

Asian Development Bank Institute (ADBI), Tokyo

*Suggested Citation:* Rövekamp, Frank (2020) : The evolution of the European Stability Mechanism: Lessons for Asian integration, ADB Working Paper Series, No. 1173, Asian Development Bank Institute (ADBI), Tokyo

This Version is available at:

<https://hdl.handle.net/10419/238530>

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## **ADB Working Paper Series**

### **THE EVOLUTION OF THE EUROPEAN STABILITY MECHANISM: LESSONS FOR ASIAN INTEGRATION**

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No. 1173  
August 2020

**Asian Development Bank Institute**

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Suggested citation:

Rövekamp, F. 2020. The Evolution of the European Stability Mechanism: Lessons for Asian Integration. ADBI Working Paper 1173. Tokyo: Asian Development Bank Institute. Available: <https://www.adb.org/publications/evolution-european-stability-mechanism-lessons-asian-integration>

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**Abstract**

The European Stability Mechanism (ESM) is a permanent institution with the purpose of providing financial stability to the 19 countries in the eurozone. It was founded in 2012 at the height of the sovereign debt crisis in Europe. Originally, the European Union and the eurozone intended to operate without a regional financial stability mechanism. However, the severity of the crisis forced the abolishment of the principal of complete fiscal self-reliance for each member country. During the course of the crisis, the ESM and other organizations provided financial assistance to the crisis countries—Greece, Ireland, Portugal, Spain, and Cyprus—amounting to €400 billion. This may have helped to contain the crisis, but the regional financial stability arrangement in Europe has suffered from organizational and procedural over-complexity. Reforming the system is proving difficult because of disunity among eurozone members. The regional financial stability mechanism in Asia, the Chiang Mai Initiative, was created after the Asian crisis of 1997/98 and could therefore be developed without immediate pressure. There are signs that it lacks effectiveness, however, because of an insufficient funding base and a lack of capabilities to provide reform programs and surveillance for crisis countries. Here, the experiences in Europe can provide hints for a way ahead in Asia: committed funding should match the needs of a potential crisis. Furthermore, organizational capabilities need to be enhanced, but without creating undue complexities in decision-making and institutional setup.

**Keywords:** European Stability Mechanism, regional financial stability, sovereign debt crisis, Chiang Mai Initiative

**JEL Classification:** F3, H6

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## 1. INTRODUCTION

The European Stability Mechanism (ESM) was formally founded at the height of the European sovereign debt crisis in 2012 in order to provide and improve eurozone financial stability. The ESM is the institution that grants financial assistance to member countries of the currency area facing fiscal or financial crisis with the potential to affect the stability of the eurozone as a whole. The ESM and its predecessor, the European Financial Stability Facility (EFSF), have accordingly granted loans to Greece, Ireland, Portugal, Spain, and Cyprus. Opinions differ widely, however, with some seeing the ESM as an adequate vehicle for solidarity and risk sharing, while others regard it as a rather dysfunctional organization, encouraging moral hazard among its members. Notwithstanding, movements to upgrade the ESM are under way, with discussions focusing on enhancing its lending capabilities, equipping it with economic surveillance competencies, and softening conditions to access funds. There are even calls to transform the ESM into a European Monetary Fund (EMF), thereby granting it powers to provide financing not only in times of systemic crisis, but also for more ordinary economic development purposes.

Whilst the ESM helped to contain the European sovereign debt crisis and thus fulfilled its purpose in the short term, judgment on its long-term effects on economic integration in Europe is still pending. The ESM story nevertheless offers valuable lessons for Asian integration by providing hints for the following questions: Is a financial stability mechanism needed at all for the promotion of regional integration? If yes, what should be its scope? Finally, what kind of organizational design and which decision-making processes should be devised, or at least be avoided, to assure effective functioning of the mechanism?

Accordingly, this paper will analyze and evaluate the function of the ESM as a regional financial safety mechanism, and will formulate some lessons to be drawn for regional integration in Asia. For this purpose, the founding process of the ESM will be reviewed, as well as its functioning in concert with other European institutions and the International Monetary Fund (IMF). Recent developments and reform proposals will then be discussed. Finally, policy proposals to strengthen the regional financial safety net in Asia will be formulated based on the European experience.

## 2. THE EUROPEAN DEBT CRISIS AND THE FOUNDATION OF THE ESM

The European Union and the eurozone were not constructed under the premise of risk sharing through the creation of a common emergency fund. In fact, the opposite was the case. To safeguard financial stability, the Stability and Growth Pact of 1997 obliged each country to adhere to fiscal stability rules as codified in the Maastricht criteria (European Commission 2019, 7–13). According to these rules, a member state should achieve a GDP-to-debt ratio of not more than 60%, while the national budget deficit is targeted at 3% or below. To stress this point, Article 125 of the Treaty on Functioning of the European Union (TFEU, which together with the Treaty of European Union forms the constitutional basis of the EU), the so-called no bailout clause, states that neither the union nor member states shall be liable for or assume the commitments of other member states (EUR-Lex 2019). The European Union was not meant to provide a fiscal insurance mechanism. Each member state was to be responsible for its own financial health.

Things dramatically changed in the wake of the global financial crisis of 2008/09, when state debt soared to finance fiscal programs to avoid even deeper recession, or to recapitalize banks on the verge of failure. The increased debt levels led to a crisis first in Greece in early 2010. Yields of Greek government bonds increased steeply as soon as it became known that Greece had significantly underreported its budget deficits for several years running. It quickly became apparent that Greece would lose access to the financial markets and face insolvency without financial support from the other eurozone member states. Although the Greek economy only amounts to about 2% of the European Union GDP, strong contagion effects were feared in the case of Greek insolvency, as many banks were holding Greek government bonds at the time and were still considered vulnerable immediately following the global financial crisis.

The eurozone member countries decided to provide financial support initially through the so-called Greek Loan Facility, which pooled bilateral credits given to Greece by individual countries. Especially at the insistence of Germany, the IMF also joined the ranks of the creditors. The entire program reached a total volume of €80 billion (Moschella 2016, 806–808).

As a debt crisis was also looming in countries like Ireland, Portugal, and Spain, the eurozone members sought a better institutional basis for financial crisis management and founded the European Financial Stability Facility (EFSF) in June 2010. The EFSF was equipped with a lending capacity of €400 billion, but had a limited time span of three years; the no bailout clause did not allow for a permanent mechanism without changes in the TFEU (Tomkin 2013, 170, 171).

The EFSF soon had to grant financial assistance to Ireland, in November 2010, and to Portugal, in May 2011. In order to overcome the three-year tenure of the institution, the euro area moved on to establish the ESM as a permanent mechanism, which was not an easy task in the no bailout legal environment. For this purpose, an amendment to the TFEU was initiated, allowing for such a mechanism if the stability of the euro area as a whole is endangered, and the granting of financial assistance is based on strict conditions. The ESM was established in February 2012 and has the following features (ESM 2019a).

- The mechanism is based on an inter-governmental agreement and is therefore not an institution within the legal framework of the European Union. There are thus no supervisory or other legal relationships with EU institutions like the European Parliament, the European Council, or the European Commission.
- The ESM assumes the entire operations of the EFSF, which did not engage in new programs after 2013, but continues to be a legally separate entity.
- The ESM is designed as a pure financing vehicle: the formulation and negotiation of economic reform programs for crisis countries and surveillance are beyond its scope. According to the Treaty on the ESM, these tasks are assigned to the European Commission (EC), the European Central Bank (ECB) and, “wherever possible”, the IMF (ESMT 2012, Article 13). Notwithstanding, the ESM has built up internal capacities for debt sustainability analysis, the so-called early warning system, thus fostering its own resources for surveillance (Guttenberg 2017, 14). The European financial stability arrangement does not rest on one institution, therefore, but on the complex cooperation of a number of institutions.
- The ESM has a lending capacity of €500 billion. Besides loans to sovereign states, financial assistance can also include support to banks, interventions in the primary and secondary bond markets, and precautionary credit lines.

- The highest decision-making body of the ESM is the Board of Governors, consisting of the finance ministers of the 19 member states. In most cases, new financial assistance programs have to be approved by the Board unanimously. Qualified majority voting with a threshold of 85% is possible in emergency situations, but even then, the three largest member states—Germany, France, and Italy—have a veto (Guttenberg 2019, 3).

The establishment of the EFSF and ESM was challenged before several courts of member states and before the European Court of Justice on the grounds of violating the no bailout clause or circumventing EU law. The latter argument was based on the fact that by setting up the ESM on the basis of an inter-governmental treaty, an institution was formed which could heavily influence the workings of the European economic and monetary union, but which was not overseen by the European Parliament or any other EU institution. The cases were rejected by the courts, but in the process, the German Federal Constitutional Court strengthened the right of the German Parliament to preapprove any major commitment the government may make in connection with financial assistance programs by the stability mechanism (Tomkin 2013). Notwithstanding the verdicts, a widespread feeling remained that the euro area had twisted and bent its rules to the maximum possible degree. The cumbersome share of work between the ESM on the one hand, and the EC, the ECB, and the IMF on the other was presumably also designed to alleviate concerns with regard to the no bailout clause and the positioning of the ESM outside the EU legal structure.

### **3. ACTIVITIES AND EVALUATION OF THE ESM**

Soon after the outbreak of the Greek crisis, other countries followed suit, seeking financial support from the EFSF and later from the ESM. During this phase of ‘firefighting’, not much time could be spared for optimization of the organizational arrangements and processes. The issues with the latter only fully emerged after the crisis calmed down.

#### **3.1 The ESM in Action**

The ESM and its preceding organization, the EFSF, engaged in a range of crisis programs (ESM 2019b).

In November 2010, a financial assistance package was approved for Ireland. Already in 2007 a property market bubble had burst there, and the government had given blanket guarantees to the domestic banks involved. With no further access to financial markets at reasonable conditions, the government turned to the EFSF. Support totaling €67.5 billion was provided by the EFSF, eurozone member states, the EU, and the IMF. Repayment of the EFSF loan is scheduled for the period 2029–2042.

A financial assistance package for Portugal was approved by the EFSF in May 2011. A total of €78 billion was disbursed jointly by the EFSF, the EU, and the IMF. Repayment of the EFSF loan is scheduled for the period 2025–2040.

In July 2012, the ESM approved loans to recapitalize Spanish banks, which were on the verge of failure due to the bursting of a property bubble. In this case, €41.3 billion was provided solely by the ESM, as the IMF has no facility for direct bank recapitalization. The repayment of the ESM loan is scheduled for the period 2022–2027.



Cyprus was hit by a full blown banking crisis in 2011, and financial assistance was finally approved by the ESM (€9 billion) and the IMF (€1 billion) in April 2013. Repayment of the loans is due between 2025 and 2031.

Whereas Ireland, Portugal, Spain, and Cyprus were able to regain access to the financial markets after these programs, Greece proved to be more intractable. Soon after the first program in 2010, it emerged that the optimistic projections and assumptions for fiscal and economic recovery were widely off the mark. Instead, the situation worsened. A second program amounting to €141.8 billion, with the EFSF as the main lender and the IMF, was negotiated in 2012. This was accompanied by a 'voluntary' write-off for private bond holders in the amount of €100 billion (Moschella 2016, 812–817). Still this proved to be insufficient, and Greece was thrown into turmoil again in 2015 after national elections and a change of government in January 2015. In June 2015, the country defaulted on repayment of an IMF loan. Nevertheless, the euro area stepped in again, and a third financial assistance program led by the ESM was agreed in August 2015. The total loans to Greece by the EFSF/ESM and the IMF reached €280 billion. However, debt relief measures were devised as well: interest rates were reduced, and the amortization of the EFSF/ESM loans was extended to the year 2070 (ESM 2019b).

The Greek story revealed the difficulties stemming from the complex institutional setup of the European regional financial stability arrangement, with different viewpoints and different interests of the institutions requiring reconciliation.

Differences quickly emerged, especially with regard to the IMF (IMF 2018). The IMF was part of the European financial stability arrangement for several reasons, particularly as a result of the insistence of Germany. First of all, European institutions had no experience in formulating and supervising economic reform programs to overcome fiscal crises. Most importantly, however, the IMF was supposed to enforce strict conditionality, which the European institutions were likely more reluctant to do. Finally, the participation of the IMF was also deemed important to avoid potential competition between global and regional financial stability mechanisms.

As early as 2011, the IMF doubted the sustainability of Greece's debt (IEO 2017). It therefore requested a write-off involving all private and public creditors. This was strictly rejected by the European institutions, however, for various reasons. The member countries of the ESM feared the wrath of the electorate, as governments had promised that in spite of the rescue packages no financial loss was to be expected, leaving the no bailout clause more or less intact. The ECB, in particular, feared deeper direct consequences (Moschella 2016, 808–812). Within the framework of its quantitative easing, the ECB had acquired a significant stock of Greek government bonds and feared that its monetary policy would lose credibility should a devaluation of its holdings take place. Therefore, a write-off for private investors only was accepted, which was labeled 'voluntary' but only achieved by exerting significant political pressure on the private banking industry. The rift between the IMF and European institutions became ever more pronounced. Greece, on the other hand, appeared to see this as an opportunity to lessen the influence of the IMF's role in the program's surveillance, or possibly even to promote its exit. In April 2019, the Greek government announced its intention to repay the IMF loans early despite the objections of other Eurozone members (Reuters 2019a).

The ESM program for Greece was formally concluded in August 2018, and the country successfully tested the financial markets again in January 2019 with a €2.5 billion bond issue (Bloomberg 2019). With a sovereign debt-to-GDP ratio of over 180% (Trading Economics 2019b), its financial health remains precarious. This ratio is projected to be reduced by only 25% by 2060 (EMS 2019b), considering the measures agreed upon by the European institutions and the IMF. In the meantime, Greece has already announced

that it will deviate from some of these measures by increasing the minimum wage for the first time since the debt crisis erupted (Reuters 2019b).

### **3.2 Between Solidarity, Risk Sharing, Moral Hazard, and Institutional Over-complexity: The Pros and Cons of the ESM**

Proponents of the ESM and the financial stability arrangement around it consider the financial assistance programs necessary and successful, and a good example for how solidarity and risk sharing between the member countries of the Monetary Union can overcome even a very severe crisis. According to this viewpoint, the euro area has been successfully stabilized by the rescue packages. The bond yields for all crisis countries except Greece have quickly come down to normal market levels. Ireland concluded its program in December 2013 and has become one of the most vibrant economies in Europe ever since. Portugal exited the program in June 2014 without needing further assistance. The budget deficit was reduced, and growth resumed again. Spain, upon ending the program in December 2013, started to repay the loans earlier than required, and signaled a strong recovery. Cyprus finally exited the program in March 2016, after successfully reforming its financial industry (ESM 2019b). Only the case of Greece has proven to be more difficult; without the EFSF and ESM, however, the country may have had to face insolvency and leave the eurozone. A breakup of the Monetary Union could have been the consequence.

Right from the very beginning of the rescue operations for Greece, however, the emerging financial stability arrangement was criticized on the grounds of classic moral hazard arguments. Moral hazard argues that countries that assume that they will be rescued by external funds in times of even self-inflicted fiscal crisis will have much less incentive to enforce fiscal discipline and keep national debt under control (World Finance 2012). The strict conditionality of the programs may be meant to minimize moral hazard behavior, but critics point out that the credibility of such 'strict' conditionality was impaired from the very start with the de facto abolishment of the no bailout clause, which is considered to be the ultimate defense against moral hazard. If the no bailout principle is not enforceable from the start, goes the argument, how can program conditions be expected to change anything?

The prolonged Greek crisis has indeed offered various indications of moral hazard behavior. Agreed upon economic reform measures were frequently delayed or not met. Examples include the slow pace of the privatization of state assets, or the reform of the pension system, which has not progressed sufficiently. Following the national elections in 2015, the new government even announced that it would cease to cooperate with the 'troika' as EC, ECB, and the IMF were collectively referred to at that time. The crisis peaked again in the same year, with Greece on the verge of leaving the eurozone. After prolonged and emotionally charged discussions, compromises were made and the EC, ECB, and IMF were able to continue their work, albeit not under the name 'troika' anymore, but collectively called 'The Institutions' (Darvas 2017, 28, 29) from that time onward. The Greek crisis of 2015 has significantly contributed to growing disillusionment and discontent with the EU and the euro.

The latest example of presumably unabashed moral hazard concerns Italy (CNBC 2019). After the populist Northern League and the Five Star Movement formed a coalition in May 2018, the government revoked its commitment to restore fiscal health and reduce the high debt level. Instead, it introduced welfare programs such as the basic universal program for the poor, thereby guaranteeing a minimum income for all citizens, and promised tax cuts. The level of bad debts in the banking sector remains largely unresolved, which poses another threat to Italy's financial stability. The budget deficit and government debts are expected to soar again in the coming years, but the government, even after its new formation without the populist Northern League in September 2019, appears to be unimpressed. Italy well may have concluded that the eurozone will avoid the insolvency of one of its members at all costs, no matter how tough the no bailout rhetoric may be. With gross state debts of more than €2.3 trillion (Trading Economics 2019a), however, an Italian debt crisis would overwhelm the rescue capacity of the ESM.

Beyond these specific cases, critics of the ESM point out that the eurozone as a whole is still far from sustainable stability and strong economic performance. The growth outlook for the euro area remains weak, and other issues like the high unemployment rate in countries such as Spain offer little incentive to move vigorously toward restoring fiscal health. Unexpected political problems, like those in France with the Yellow Vest protests which erupted in October 2018, easily lead to loosening budgetary commitments. France has already compromised on keeping its budget deficit below 3% in the coming years (CNBC 2018).

While it is debatable whether the European financial stability arrangement contributes to strengthen the eurozone or rather to moral hazard and fiscal profligacy, the institutional complexity in terms of number of players and dividing responsibilities can only be considered dysfunctional. This will not be simply mended by giving the ESM a role in the design and monitoring of financial assistance programs, as these duties will be shared with the EC, leading to further possibilities for friction.

Disagreements between the European institutions and the IMF have already been pointed out above. The involvement of the ECB, however, has raised problems of a different nature (Moschella 2016, 808–812).

The main mandate of the ECB is to safeguard price stability in the eurozone—i.e., to prevent deflation and excessive inflation. With its quantitative easing program, the ECB has made a foray into indirect state financing. The purchasing of government bonds of the countries in the eurozone has brought down the yields and thus contributed to recovery in the crisis countries. In the process, the ECB has also lowered the quality standards of the securities it is willing to accept as collateral for credits to commercial banks (Nyborg 2017). This has especially helped Greek banks. The ECB can therefore hardly be considered a neutral partner in the formulation and monitoring of the ESM financial assistance programs, and it has indeed signaled some discomfort with this role. The ECB is certainly eager to avoid the insolvency of a crisis country, as it would probably then be expected to be the last resort lender, even if this would further blur the line between monetary and fiscal policy and thus compromise the credibility of the central bank. This potentially impairs the ECB's role of surveillance of crisis countries.

To sum up, proponents of the ESM see the European financial stability arrangement as a manifestation of solidarity and risk sharing within the euro area. Furthermore, the ESM has shown itself to be indispensable in saving the Monetary Union in times of crisis.

Critics, on the other hand, point out that:

- The moral hazard problem, which goes hand-in-hand with any financial safety net, is a greater threat in the eurozone as a result of effectively breaking the no bailout clause, which in turn impairs the credibility of even strict conditionality.
- The whole institutional financial stability arrangement between the ESM, EC, ECB, and IMF is very complex and fraught with conflicts of interest.

## **4. FROM EUROPEAN STABILITY MECHANISM TO EUROPEAN MONETARY FUND?**

Notwithstanding the aforementioned issues, an even larger role for the ESM is being considered in the context of discussions regarding strengthening the European Monetary Union (Guttenberg 2017).

Some proposals center on the conditions for access to the ESM-funds, which so far can only be tapped in cases where the stability of the euro area as a whole is at stake and all member states unanimously approve a program. A ‘rainy day’ fund, which could be used in times of asymmetric shock or downturns, as proposed by the Managing Director of the ESM, Klaus Regling (ESM 2018), or a ‘rapid response facility’ should lower the bar for access and facilitate speedier decision-making in disbursing funds.

Other proposals focus on the scope of the ESM, which is currently limited to raising, administering, and disbursing program funds, whereas the formulation of economic reform measures, negotiations with crisis countries, and surveillance are carried out by the EC, the ECB, and the IMF. Concentrating all these activities under the ESM roof would involve a significant build-up of expertise and staff resources. Nonetheless, it is seen as a solution to the manifold problems associated with the institutional complexities of the current setup.

Finally, there are proposals to change the legal structure of the ESM and bring it into the framework of European Law. This should resolve any remaining doubts about the legitimacy of the mechanism.

The reform discussions gained traction after the newly elected French president Macron made a range of proposals to strengthen the European Union. The ideas included a separate budget for the euro area and much closer fiscal coordination among the member countries, potentially even under the responsibility of a Euro Area Finance Minister (Macron 2017). Certainly, these ideas influenced the European Commission’s proposal in 2017 to transform the ESM into a European Monetary Fund (EMF) under Union law with enhanced competencies (European Parliament 2019).

Despite all well-intentioned proposals, real reform has not progressed. This is largely due to the fact that the question of ESM reform is embedded in the larger issue of reform of the Monetary Union. How much fiscal coordination, especially regarding tax and social security, is needed? How strictly or flexibly should the fiscal rules be applied? How much risk and burden sharing are acceptable in cases of asymmetric downturns in the area? To what extent should the ECB restrict measures which can be interpreted as trespassing into the realm of state financing? As long as these questions remain highly controversial among the member countries of the Monetary Union, significant ESM reforms, which would require a unanimous decision to change the ESM treaty, remain elusive. Additionally, transforming the ESM treaty into EU law would require a further unanimous decision in the European Council and the approval of the European parliament. Finally, depending on the extent of the transfer of surveillance rights from the

EC to the ESM, it is possible that even changes in the TFEU may be required, which would necessitate parliamentary ratification procedures within the EU member countries, including those which are not members of the monetary union (Guttenberg 2017, 12, 13). At present, these legal hurdles appear to be insurmountable.

The fact remains, therefore, that the entire European institutional arrangement for regional financial stability is very hard to improve or reform, as any significant changes require unanimous decisions by all member countries of the Monetary Union and might then still be challenged in the courts with a good chance of success. The advancement of the ESM into a European Monetary Fund not only by name but also in substance is thus elusive for the foreseeable future. Against this backdrop, it is hardly surprising that ESM reforms agreed upon at the Euro Summit in December 2018 will not significantly alter the current limitations and procedures (European Council 2019). The only substantial change envisioned is a role for the ESM in the eurozone banking union. The ESM is supposed to resume a backstop function for the Single Resolution Fund, which has been established to cover potential bank insolvencies in the future (ESM 2019c). The ESM is furthermore scheduled to have a role in formulating program conditionality together with the EC. Even these limited reforms, however, are currently (as of January 2020) stalled. Italy raised objections, the government requesting further changes in the design of the European Banking Union before agreeing to the ESM reform (New Europe 2019). The necessary change to the ESM treaty will furthermore require the approval of national parliaments in some member states. In the case of Germany, discussion is underway as to whether this approval may even need a two-thirds majority on constitutional grounds (Schorkopf 2018). It is therefore likely that the German Federal Constitutional Court will also be involved before Germany can give its final consent to the treaty amendment (Tofall 2019).

## **5. PROVIDING REGIONAL FINANCIAL STABILITY IN ASIA**

Regional financial stability has also been an issue since the Asian crisis of 1997/98. Contrary to the situation in Europe, however, the discussion only developed after the crisis, not at its onset. On the one hand, this has allowed more careful deliberations with regard to organizational design and processes; however, without strong pressure, progress has been incremental and the outcome remains largely untested. The European financial stability arrangement, where the crisis experience revealed its pros and cons, can therefore provide hints for effective institutional advancement in Asia.

During the Asian crisis, the foundation of an Asian Monetary Fund (AMF) as a regional counterpart to the IMF was proposed by Japan. Resistance from the US and disunity among the Asian countries quickly led to abandonment of the idea, presumably because a duplication of tasks and competition with the IMF were feared (Park 2017, 75). Instead, the ASEAN member countries and the People's Republic of China, Japan, and the Republic of Korea (ASEAN +3) settled on the less ambitious idea of setting up a network of currency swap agreements among each other. This way, the Chiang Mai Initiative (CMI) took shape in May 2000. The CMI increased its scope over time. In the beginning, the swaps were only supposed to cover short-term liquidity problems and thus had very short-term maturities. These were extended step by step. Also, the agreed-upon swap amounts were increased, and the network of bilateral swaps transferred into a multilateral scheme in 2010, the Chiang Mai Initiative Multilateralization (CMIM). Furthermore a regional surveillance unit, the ASEAN +3 Macroeconomic Research Office (AMRO), accorded the legal status of an international organization in 2016, was

set up in Singapore with responsibility for monitoring the economic performance of the member countries at regular intervals and implementing regional financial arrangements (AMRO 2019).

The CMI has not been active until now, even though two of its members, the Republic of Korea and Singapore, were in need of US dollars in the wake of the global financial crisis at the end of 2008. Instead of turning to their own regional financial safety net, they turned to the US to conclude bilateral swap agreements (Park 2017, 64).

This has illuminated the weaknesses of the CMIM, which become even more apparent when contrasted with the European experience.

- Contrary to the ESM, the CMIM provides pledged funding and not paid-in funding. In the case of force majeure, however, member countries can withdraw from their pledges and not contribute even if asked to do so, though the European sovereign debt crisis showed that funding needs to be available without delay in order to calm markets. There is no time for second thoughts during crisis fighting.
- The total financing volume of the fund amounts to \$240 billion. Furthermore, a single country can only draw a fraction of this amount, ranging from \$38.40 billion for Japan to \$0.30 billion for Brunei Darussalam or the Lao People's Democratic Republic. This appears to be wholly inadequate in times of a severe emergency like the Asian crisis of 1997/98 or the financial crisis of 2008/09. The Republic of Korea and Singapore's bilateral swap with the US each had a volume of \$30 billion. Funds in the order of over €400 billion were necessary to contain the debt crisis in Greece, Portugal, Ireland, and Cyprus, all of which belong to the smaller economies of the eurozone. Much bigger amounts would be necessary if a financial crisis hit countries like Italy, France, or Germany.
- 70% of the funds potentially available from the CMIM are linked to the condition that the requesting country undergoes an IMF program. This further reduces the independent firepower of the mechanism, and may also negatively influence its speed of decision-making. This issue corresponds with the European experience, where the rather unstructured cooperation with the IMF has led to frictions and delays in the process.
- The ability of AMRO to function as a credible macroeconomic surveillance unit which formulates, negotiates, and monitors economic reform programs is questionable due to inadequate capacity and standing. The lessons from the European sovereign debt crisis, however, underline the need for independent design and monitoring of economic reforms to improve the situation in crisis countries.

Some see the CMI, therefore, as a forum for enhancing trust building and mutual understanding between the participating countries, but generally inadequate and perhaps even useless in times of a real world crisis (Pascha 2014).

Plenty of proposals have been made to improve the mechanism (e.g., Azis 2012; Park 2017). Among them is the establishment of a paid-in fund, with contributions from the currency reserves of the participating countries. The sum of these reserves is a multiple of the total financing capacity of the CMIM. Such a fund could be administered within the institutional and decision-making framework of the CMIM, or by a complete separate entity. It could furthermore raise additional capital through the issue of bonds, thus enhancing its crisis fighting capabilities (Park 2017, 67–77).

Such bold ideas remain proposals. There is no indication that a serious discussion on such ideas has even started among the relevant decision-makers. The reason for this

appears to be that a regional financial safety mechanism is embedded in the larger question of regional economic integration. If there is no implicit or explicit understanding of how far economic integration should go, then there is no basis for the design of a credible financial safety mechanism (Grimes 2011). Considering the manifold political differences between the participating members of the ASEAN +3 area, it is not surprising that a consensus on the extent of economic integration is still elusive.

## 6. CONCLUSION AND POLICY RECOMMENDATIONS

Economic integration can be defined as a process whereby measures are designed with the aim of abolishing discrimination between economic units of different national states (Balassa 1961). It usually progresses in a stepwise fashion by reducing tariffs and other barriers against the free flow of goods and services and promoting the free movement of capital and labor. Further integration can be achieved with managed exchange rates and the coordination of fiscal policies, especially in the areas of tax and securities, which can then lead to a unification of monetary, fiscal, social, and countercyclical policies.

The welfare effects of economic integration are considered positive, but consideration needs to be given to the impact on income distribution and the possibility of asymmetric shocks (Stiglitz 2010), as there will always be winners and losers in the process. Moreover, if the development is seen largely to favor certain regions or groups, the integration process may come under severe political pressure. The deeper the integration is, the more coordination is needed between the participating countries. Similarly, as economic integration progresses, the need for economic insurance or a financial stability mechanism increases. It appears, however, that more research is required on the relationship between the degree of economic integration and the type and level of financial stability mechanism.

Seen from this perspective, two problems can be identified with regard to the way regional financial stability has been handled in Europe.

- One is the widely discussed fact that, with respect to the Monetary Union, the euro area has got economic integration in the wrong order. With little or no fiscal cooperation so far, total monetary integration is bound to lead to imbalances and financial instability also in the future.
- With the no bailout clause, the European Union flatly denied the need for any economic insurance or a regional financial stability mechanism in any form, despite its intention of ever closer economic integration. When this position could no longer be maintained as a consequence of the financial crisis, the hastily constructed solution was bound to suffer serious shortcomings such as lack of credibility, legal vulnerability, and institutional awkwardness. Mending this will remain an arduous task for the foreseeable future.

Asia may draw the following lessons from the European experience.

- Steps should be taken to enhance the credibility of the regional financial stability mechanism, so that is seen to be of real practical use in times of need. For this purpose, a centralized fund made up of paid-in contributions by participating members could deliver a signal of stronger commitment than the current system of pledged funding. Initially, it may be sufficient to raise an amount which would cover a crisis in one of the smaller countries of the region, as probably no amount of paid-in capital would be sufficient to cover a crisis in one of the bigger countries or the entire region.

- The institutional structure and decision-making procedures should be kept transparent and simple. Only one institution—for example, an enhanced AMRO—should be in charge. The decision-making procedures should allow at least qualified majority voting, as experience shows that unanimous decisions or veto powers may easily bring the whole system to a halt.
- The relationship with the IMF needs to be recalibrated in such a way that it does not hinder quick and independent action within the region—as the current linkage between CMIM funding and IMF oversight may do—and that competition between the IMF and the regional mechanism does not arise. The literature offers various proposals to this end (Rhee, Lea, and Shahin 2013). A rather straightforward solution may be an agreement with the IMF to provide financial assistance to the regional financial safety mechanism in times of crisis, rather than directly to the individual countries.



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