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**REFLECTIONS ON THE
DEVELOPMENT OF REGIONAL
FINANCING ARRANGEMENTS:
EXPERIENCE FROM EUROPE**

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Abstract

This paper sheds light on the development of European Regional Financing Arrangements (RFAs) and the role of these financial backstops in resolving the recent euro area crisis. It documents a significant dual shift in the design of regional firewalls in Europe, from bilateral to multilateral financial assistance and from temporary rescue funds to the permanent European Stability Mechanism. This evolution epitomizes policy makers' deepened understanding of the root causes of the euro area crisis and the way forward to manage it. Based on the European experience, the paper aims to identify some potential lessons for other RFAs, especially for the Chiang Mai Initiative Multilateralization (CMIM) in East and Southeast Asia. The change in mentality about crisis resolution revealed the importance of having a deep understanding of the origin of region-specific shocks first, which will determine an RFA's mandate and operational scope. Within the remit of the mandate, which can evolve over time, an RFA develops and reshapes its lending tools and policies and finds the most suitable strategy to secure funding resources. The European experience could thus be useful to inspire the future evolution of the CMIM in the ASEAN+3 membership.

Keywords: regional financing arrangements, crisis prevention, crisis resolution, tool kit, governance, financial backstops, Asia, Europe

JEL Classification: F33, F34, F53, F55, G24

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1. INTRODUCTION

In the past decade, Europe has suffered two successive and interlinked crises, the global financial crisis and the euro area debt crisis. The crises encouraged policy makers to implement a package of reforms, aimed at enhancing the resilience of the European Union (EU), in particular that of the currency union, the euro area. The European Central Bank (ECB) adopted unconventional monetary policy measures to stimulate credit growth and economic recovery. EU member states revamped union-wide economic governance and policy coordination. The EU also centralized the supervision and resolution of systemically important banks with the creation of the Banking Union. Finally, severe liquidity pressures that a number of EU members faced during the crisis drove the strengthening of crisis resolution mechanisms and the creation of the European Stability Mechanism (ESM). The literature has largely focused on the effect of the ECB's monetary policy on crisis resolution, EU economic policy coordination, and progress toward the Banking Union. Therefore, this paper aims to shed light on the development of European financial backstops, so-called "Regional Financing Arrangements" (RFAs), with a particular focus on the ESM.

Another reason to focus on the European financial firewalls is that since the global financial crisis there have also been several attempts to create or strengthen RFAs in other parts of the world. For instance, the Latin American Reserve Fund (*Fondo Latinoamericano de Reservas* or FLAR) increased its subscribed capital by 40% in 2012 and the Arab Monetary Fund (AMF) doubled its authorized capital in 2013 (Cheng et al. 2018). Six members of the Eurasian Economic Community created an anti-crisis fund with \$8.5 billion in firepower in 2009, which evolved into the Eurasian Fund for Stabilization and Development (EFSF) in 2015 (Cheng, Miernik, and Turani 2019). In line with the European experience, ASEAN+3 countries pooled resources for crisis resolution and agreed on the Chiang Mai Initiative (CMI) as a response to the Asian Financial Crisis in 1997–1998. During the recent global financial turmoil, the CMI evolved from a set of bilateral arrangements into a single and multilateral contract, i.e., the Chiang Mai Initiative Multilateralization (CMIM). Its overall financing capacity increased to \$240 billion in 2014 from \$120 billion previously agreed (Cheng et al. 2018). A surveillance unit – the ASEAN+3 Macroeconomic Research Office (AMRO) – was also created in 2011 to support CMIM operationalization and decision-making.

This paper has a dual objective. First, it provides an overview of the evolution of the different layers of the financial firewalls in Europe, and the change in mentality that spurred the setting up of a euro area-specific RFA, the ESM. Second, it aims to draw some potential lessons from the European experience for East Asia. An RFA is normally set up to address regional specific issues, e.g., economic shocks to which a region is particularly prone. The literature on RFAs (such as Rhee, Sumulong, and Vallée 2013) often casts doubt on the comparability between the Asian and European RFAs, especially between the ESM and the CMIM, given their very different mandates. This paper will argue that the different mandates were fixed to deal with specific regional crises, but that they both aim to provide a regional line of defense to prevent future crises or to provide emergency liquidity to their member governments when a crisis occurs.

This paper will first present the key features of the development of European RFAs since the global financial crisis (Section 1). It will then discuss four sets of issues that were primordial in designing the European RFAs (Section 2). This section aims to shed light on: (i) what mandate an RFA assumes and what types of shocks it is created to deal with; (ii) the extent to which an RFA's tool kit should be tailored to regional needs; (iii)

the choice of an RFA's funding strategy; and (iv) the impact of the governance structure on an RFA's decision-making process.

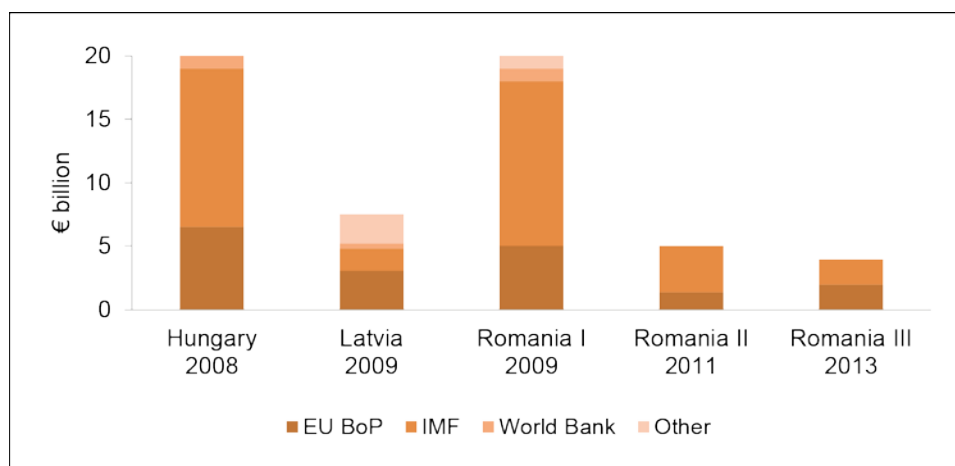
2. A CONCISE OVERVIEW OF THE DEVELOPMENT OF EUROPEAN RFAS

2.1 Crisis-Fighting Objectives Evolved from a Balance-of-Payments Focus to a Broader Financial Stability Perspective

Before the onset of the global financial crisis, the EU had only one crisis resolution mechanism, the EU balance-of-payments facility (EU BoP), designed to deal with medium-term financing constraints in member states. This facility, created in 1972 for the members of the European Economic Community (EEC), became a single facility in 1988 after the establishment of the Single Market by Council Regulation No 1969/88. Italy, Greece, France, and Ireland used this instrument in the past before the recent financial turmoil. The EU BoP facility functions like IMF loans and provides short- to medium-term foreign currency liquidity to a member state facing trade imbalances or disruptive capital flows as a result of exchange rate misalignment.

With the creation of the euro, euro area countries ceased to use their national currencies, thereby eliminating nominal exchange rate volatilities among them. Since then, only EU members that have not yet adopted the euro have been eligible for the BoP facility. The overall size of the EU BoP facility was fixed at €12 billion in 2002, compared to 16 billion in European Currency Units before the euro was created.

Eligible EU member states did not use the EU BoP facility until the Lehman Brothers collapse. Hungary was the first to apply for joint balance-of-payments assistance from the IMF and the EU BoP facility in October 2008, totaling €14.2 billion, of which €8.7 billion came from the IMF and €5.5 billion from the EU BoP. Latvia and Romania followed, requesting financial assistance in December 2008 and spring 2009, respectively. Facing increasing demand for balance-of-payments assistance, the facility's initial size proved insufficient. As a quick response to the global financial crisis, the EU twice increased the facility. Council Regulation No 431/2009 raised the limit to €25 billion in December 2008 from €12 billion in 2002 and to the final amount of €50 billion in May 2009. From 2008 to 2015, the EU BoP facility made available €18 billion for Hungary, Latvia, and Romania, of which it disbursed €13.4 billion. Romania, in particular, requested three programs in total, i.e., a loan facility and two precautionary credit lines that were not drawn upon in the end. Figure 1 shows the financial split from all contributing parties for these three countries. Hungary exited its EU BoP program on 3 November 2010 and the post-program monitoring also ended in January 2015. The Latvian BoP program ended on 19 January 2012 and the post-program monitoring in the country terminated in January 2015. The first Romanian program ended in 2011 with two successive precautionary arrangements until 2015; its post-program monitoring ended in 2018.

Figure 1: Recent EU BoP Facility Programs

Note: All figures indicate the financial commitment, which may differ from actual disbursements. Other financing sources for Latvia include Nordic countries (Sweden, Denmark, Finland, and Estonia), the European Bank for Reconstruction and Development (EBRD), the Czech Republic, and Poland. Other financing sources for Romania include the European Investment Bank (EIB) and the EBRD.

Source: the author's depiction using data from the European Commission's website https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/which-eu-countries-have-received-assistance_en.

While the EU members that have not adopted the euro were protected by the EU BoP facility against balance-of-payment shocks, euro area member states seemed unprotected on the eve of the European banking and sovereign debt crisis. A common belief was that adopting the euro removed intraregional exchange rate volatilities and the strong fundamentals of the monetary union could ensure its members had sustained access to financial markets. In addition, the Maastricht Treaty and the Stability and Growth Pact introduced clear fiscal rules aimed at ensuring fiscal discipline in the EU, especially for its members using the single monetary policy. Deviations from the preset rules would imply necessary policy corrections to restore market confidence. The recent financial tremors in Europe challenged this common view; they revealed the vulnerabilities of currency union members in the absence of a common fiscal backstop. Not only had financial markets undervalued sovereign risk in anticipation of some form of regional solidarity should crises occur, but the spillovers between currency union members proved to be much stronger than in other regions.

More importantly, the problems some euro area countries faced did not take the form of traditional balance-of-payments shocks, but stemmed instead from deep homegrown roots, for instance interlinkages between public finance and domestic banks' resilience or accumulation of fiscal imbalances over years. In some countries, domestic banks were the first hit during the crisis. To prevent a complete collapse in banking systems, European governments rescued their banks with urgent support amounting to €1.6 trillion between 2008 and 2011, the equivalent of 13% of the EU's annual GDP. The need for some sovereign governments to bail out domestic banks drove public finance into large deficits. As an example, markets cast doubt on the refinancing capacity of the Irish government when it recapitalized domestic banks. Its banking crisis then evolved into a government liquidity problem. On the other hand, as recession deepened across the euro area, it became clear that some euro area governments, such as Greece, had borrowed heavily to finance budgets for some years. The accumulation of public debt weakened market confidence and increased sovereign default probability in these countries. Tainted government creditworthiness in turn undermined domestic banks' balance sheets given their large holding of impaired

sovereign assets. In short, a sovereign-bank diabolic loop (Brunnermeier et al. 2016) was at work in the euro area crisis.

Therefore, in 2010, policy makers needed to design specific backstops to resolve the euro area financial turmoil. The objective shifted to a financial stability perspective from a pure balance-of-payments focus.

2.2 Shifting from Bilateral to Multilateral Financial Assistance

The first financial assistance support for a euro area country was bilateral. On 2 May 2010, the Eurogroup agreed to provide the so-called “Greek Loan Facility (GLF),” i.e., an €80 billion bilateral loan commitment for Greece from May 2010 to June 2013, complemented by €30 billion from an IMF Stand-By Arrangement (SBA).

Pooling bilateral loans was the quickest way to mobilize resources to help Greece. Fitch, Moody’s, and Standard & Poor’s had downgraded the country’s credit rating to junk bond status on 27 April 2010. In response, risk premiums on long-term Greek government bonds surged and the country was cut off from financial markets. At that time in 2010, euro area politicians might have thought that bilateral assistance was sufficient to help Greece, an economy that formed only 2% of euro area GDP. However, this bilateral arrangement quickly demonstrated some weaknesses. Without institutional reinforcement, bilateral arrangements were subject to economic circumstances in creditor countries. The initial €80 billion GLF commitment shrank by €2.7 billion because the Slovakian Parliament rejected the inter-creditor agreement on the Greek bailout. Ireland and Portugal stepped down from the facility when they requested financial assistance themselves, making it difficult to coordinate simultaneous financial assistance programs through bilateral arrangements.

While disbursing the first tranches of the financial aid to Greece from the GLF, European leaders started to seek regional solutions for multilateral financial assistance. In this context, the European Financial Stabilisation Mechanism (EFSM) was established in May 2010 and a month later, on 7 June 2010, the European Financial Stability Facility (EFSF) was created.

Established by Council Regulation (EU) No 407/2010, the EFSM extends the EU BoP facility to the full EU membership in order to cover euro area countries in case of financial turmoil. It can provide financial assistance “to all 28 EU Member States where (i) a Member State is experiencing, or is seriously threatened with, a severe financial disturbance; (ii) the financial disturbance or threat of financial disturbance is due to events beyond the control of the Member State concerned (Council Regulation (EU) No 407/2010).” Unlike the GLF, the EFSM is a multilateral framework, financed by the European Commission’s borrowing from financial markets. Market financing takes the form of security issues backed by the EU budget. The EFSM’s maximum lending capacity is slightly higher than the EU BoP facility, reaching €60 billion. EFSM financial assistance can be a loan or a precautionary credit line.

Since its creation, this mechanism has provided financing to Ireland and Portugal for a total committed amount of €22.5 billion (fully disbursed) and €26 billion (of which €24.3 billion were disbursed), respectively. Both countries exited their programs successfully and entered post-program surveillance. The EFSM was created to temporarily ease financial instability in Europe, and some governments, including the UK, opposed the use of the EFSM to fuel big future bailouts for EU member states. Non-euro area countries have been particularly concerned by the dual need to bolster both the EU BoP facility and the EFSM. Following the end of the Irish and Portuguese programs, the EFSM has since provided only short-term financing of €7.16 billion to

Greece, in July 2015, for the country to transfer to an ESM from an EFSF program. The Council Regulation establishing the EFSM was amended in August 2015 (Council Regulation (EU) 2015/1360) to emphasize the exceptional nature of EFSM financing, especially after the euro area permanent crisis resolution mechanism, the ESM, was created. In addition, non-euro area countries required appropriate guarantees and collateral to ensure that they would be “fully compensated in the event of non payment under the EFSM facility.”

The EFSF, another multilateral crisis resolution mechanism, was created in 2010 alongside the EFSM and it is euro area specific covering 17 countries, namely Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Malta, Portugal, Slovenia, Slovakia, and Spain. Latvia and Lithuania adopted the euro after the EFSF ceased to grant new loans in July 2013; therefore, neither country is a member state and guarantor of the EFSF. Compared with the EFSM, the EFSF has a different financial structure, giving it much bigger firepower. The EFSF receives guarantees from its member states based on a contribution key, with which it issues securities and raises funds to finance countries in need. Backed by €779 billion in guarantee commitments, the EFSF has a lending capacity of €440 billion after the Heads of State and Government agreed to increase the EFSF’s scope in July 2011. Since its inception, the EFSF has assisted Ireland (€17.7 billion commitment) and Portugal (€26 billion commitment), alongside the EFSM and the IMF. It also cofinanced with the IMF the second macroeconomic adjustment program for Greece from February 2012 to 2015 with a total financial envelope of €144 billion, making the EFSF the Greek government’s biggest creditor.

2.3 Converting Temporary Crisis Resolution Funds into a Permanent Firewall

The EFSF was only expected to exist temporarily. The EFSF Framework Agreement stipulates that the EFSF be liquidated “on the earliest date after 30 June 2013 on which there is no longer Financial Assistance outstanding to a euro-area Member State and all Funding Instruments issued by EFSF and any reimbursement amounts due to Guarantors have been repaid in full” (Article 11 of the EFSF Framework Agreement).

However, the escalating debt crisis demonstrated that temporary measures might not be enough to restore market confidence and sustain market access for countries hit by crises. The Heads of State or Government quickly reached consensus on 28 and 29 October 2010 within the European Council on a permanent crisis mechanism to safeguard euro area financial stability. While the EFSF was providing financing to the Irish, Portuguese, and the second Greek economic adjustment programs, euro area members started technical and political preparations to establish the ESM. Finance ministers of the then 17 euro area countries signed an original intergovernmental treaty to establish the ESM on 11 July 2011. An amendment was introduced shortly after on 2 February 2012 to improve the effectiveness of the mechanism. The ESM Treaty entered into force on 27 September 2012 and the ESM was inaugurated on 8 October 2012, following ratification of the Treaty by all 17 euro area member states. Latvia and Lithuania successively joined the ESM in 2014 and 2015 after becoming euro area members.

The EFSF ceased to engage in new financing programs from 1 July 2013 and the ESM then became the sole permanent crisis resolution mechanism in the euro area. The EFSF will continue managing its outstanding debt until fully repaid.

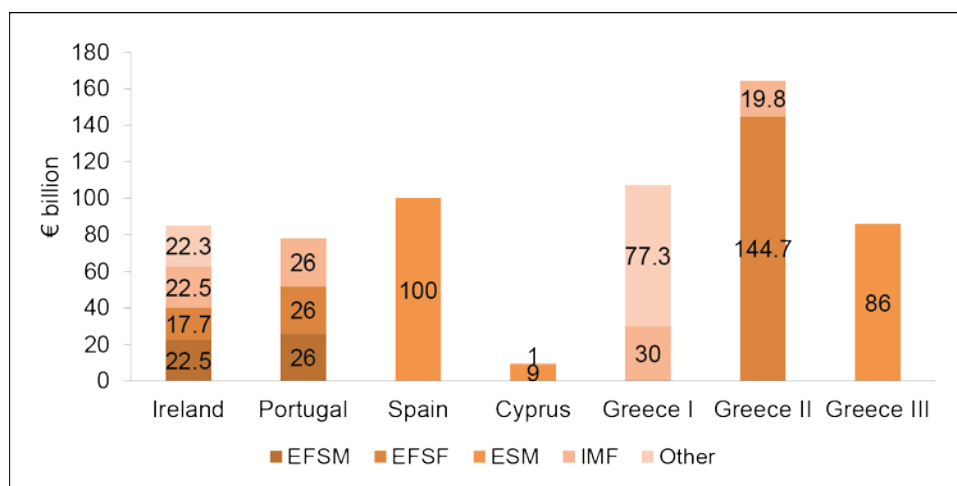
The permanent ESM institutionalization presents several advantages. First, the ESM's capital structure is much stronger than the EFSF's guarantee schemes, as ESM members paid in €80.55 billion of its capital and established clear mechanisms to mobilize the remaining €624.25 billion of callable capital in the ESM Treaty. In addition, the ESM enjoys preferred creditor status, only junior to the IMF, whereas EFSF loans rank *pari passu* with other creditors. Credit rating agencies recognize these features by assigning higher ratings to the ESM (currently rated AAA by Fitch). In addition, the funds that the EFSF raises from the market are seen as national debt, because its member states provide direct guarantee commitments. The ESM, in contrast, is considered a self-standing international institution whose liabilities – ESM securities – are detached from member states, and thus do not increase their national debt (see Eurostat's explanations, <http://ec.europa.eu/eurostat/documents/1015035/2041357/Eurostats-preliminary-view-on-the-recording-of-the-futu.pdf/ef5d168d-ebd5-4551-bc67-0dee8b60e939> and <https://ec.europa.eu/eurostat/documents/2995521/5034386/2-27012011-AP-EN.PDF/25064294-4eae-4b50-a447-60165ca9718d>).

Between 2013 and 2018, the ESM provided assistance to Spain (€100 billion financial commitment), Cyprus (€10 billion commitment), and Greece (the third Greek program, up to €86 billion commitment). With Greece exiting its ESM program in August 2018, all three countries terminated their programs and entered post-program monitoring. Figure 2 illustrates the involvement of the EFSF and ESM in all euro area programs in cooperation with other peer institutions.

The development of European RFAs since 2010, in particular the transition from temporary resolution mechanisms to the permanent euro area financial backstop, also required overcoming various legal hurdles. Before the crisis, the EU Treaties did not allow temporary transfers among member states for crisis resolution. To set up the ESM, EU member states decided to make crisis resolution an explicit option for euro area members under a set of defined conditions. Using a simplified procedure for Treaty change foreseen in Article 48(6) of the Treaty on the European Union, the European Council introduced in 2010 a third paragraph into Article 136 of the Treaty on the Functioning of the European Union (TFEU): “The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.”

In addition, a few national courts, such as those of Germany, Ireland, and Estonia, judged the compatibility of the financial assistance under an ESM program and the procedure for capital calls with the EU Treaties. The legal questions focused on whether member states have the right to establish a permanent crisis resolution mechanism, whether the ESM subverts the EU's coordination role for economic policies, and whether the ESM financial assistance violates the “no-bailout principle” enshrined in Article 125 of the TFEU. At the end, the European Court of Justice (ECJ) confirmed the compatibility of setting up a permanent crisis resolution mechanism and providing financial assistance to member states with EU Treaties in the Pringle judgement (case C-370/12), which was exceptionally rendered in a plenary session. The preliminary ruling was rendered in a record time of four months. As a result, financial assistance among euro area member states is legalized and subject to two cumulative conditions. First, the country receiving assistance must remain responsible for its commitments to its creditors; and second, financial assistance is subject to strict conditionality, to propel the beneficiary member state into implementing a sound budgetary policy.

Figure 2: Euro Area Programs and Relative Financial Contributions



Note: All figures indicate the initial financial commitment, which may differ from actual disbursements. Other financing for Ireland comes from bilateral loans from Sweden, Denmark, and the United Kingdom, as well as funds from the Irish Treasury and National Pension Reserve Fund. Other financing for Greece I comes from the pooled bilateral loans from European countries, the so-called “Greek Loan Facility.” The undisbursed amounts under Greece I were transferred to Greece II.

Source: the author’s calculation.

To conclude, the EU has established or strengthened three layers of protection against future economic shocks since 2009. The ESM is the permanent crisis resolution mechanism for euro area financial stability, replacing the temporary crisis resolution fund – the EFSF. EU members outside of the euro area can benefit from the EU BoP facility for balance-of-payments shocks. The EFSM covers the entire EU membership to prevent or treat a severe financial disturbance in exceptional circumstances.

3. SOME REFLECTIONS FROM THE DEVELOPMENT OF EUROPEAN RFAS

The overview of European RFA development sheds light on a number of questions that are crucial for an RFA to be functional and to respond to specific regional needs for crisis prevention and management. Building upon the ESM’s experience, this section highlights four core and interlinked issues: an RFA’s mandate and the types of shocks it aims to tackle, its tool kit design, its funding strategy, and how its governance structure influences decision-making.

3.1 A Specific Mandate to Deal with Specific Shocks

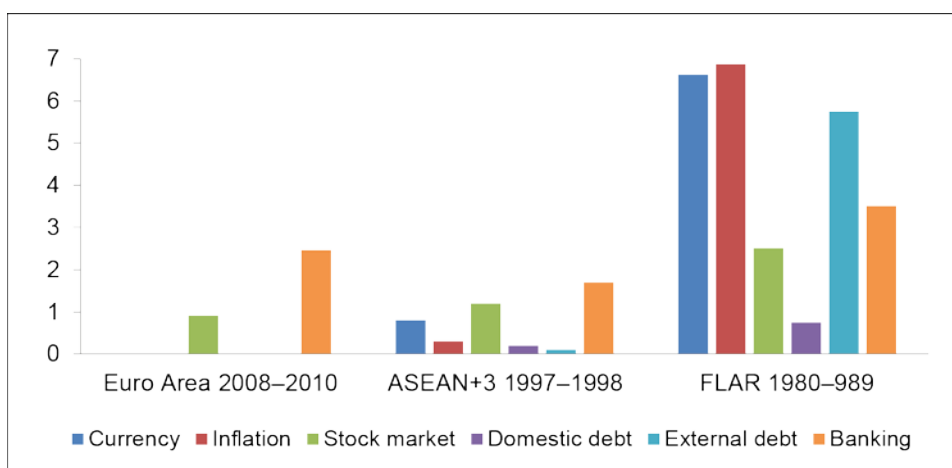
An RFA is often created in a specific context to fulfill a clearly defined regional mandate. Its mandate, i.e., what an RFA is created for and what kinds of shocks it is intended to deal with, will condition the operational features of the institution. Article 3 of the ESM Treaty states that “the purpose of the ESM shall be to mobilise funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its member states.” The ESM’s mandate in safeguarding euro area financial stability is closely related to the types of crises this financial backstop is supposed to combat. In contrast to other regions, which are mostly

vulnerable to foreign-currency capital reversals or exchange rate misalignments, the euro area has primarily faced intraregional imbalances and a sovereign-bank feedback loop in recent crises. The transmission channels between public finance and banking sector resilience are particularly strong in a currency union. In comparison, the CMIM's core objective is to address balance-of-payment difficulties, and to alleviate member states' short-term US dollar liquidity shortages.

Historical crisis data compiled by Reinhart and Rogoff (2011) also suggest that the euro area and the ASEAN+3 region faced different shocks in the past, thereby motivating the distinct mandates of their regional financial firewalls. Figure 3 shows that while the euro area was mainly facing a banking crisis in 2008–2010, the 1997–1998 Asian financial crisis was principally a twin currency-banking crisis with implications for stock markets. In comparison, FLAR member countries experienced shocks of different natures during the Latin American crisis of the 1980s: Currency depreciations, inflation surges, and external debt problems were the most salient. Therefore, in designing financial firewalls, the euro area mostly targeted financial stability, especially banking sector resilience. The ASEAN+3 region needs to tackle potential twin crises with currency mismatches. And the FLAR memberships ought to add an additional dimension to include foreign debt management.

An RFA might also need to adapt its mandate to the changing regional and international environment to deal with new challenges and risks. The role of the ESM in euro area programs has evolved over time following the shareholders' reviews. At the beginning, the EFSF – the ESM's predecessor – functioned as a cash machine, only responsible for raising money and disbursing loans. The ESM has taken on additional tasks and has been more closely involved in the design and monitoring of the programs. For instance, the ESM led the debt sustainability analysis in the ESM Greek program. What was first a troika, has become a quartet.

Figure 3: Average Occurrence of a Given Crisis in RFA Memberships



Note: Crisis classification and data come from Reinhart and Rogoff (2011). Reinhart and Rogoff's database includes only 11 euro area countries and nine ASEAN+3 countries while FLAR's full membership, i.e., eight countries, is covered. The average occurrence of a crisis is calculated as the total number of shocks divided by the number of countries in the sample for a given RFA.

Source: the author's depiction based on Reinhart and Rogoff (2011).

Currently, EU countries are working towards strengthening the currency area with many new reforms, including assigning a bigger role to the ESM in safeguarding euro area financial stability. EU member states have already agreed for the ESM to provide a credit line to the newly established Single Resolution Fund (SRF) in the Banking Union when its funds to save systemically important banks fall short. This would require a change of the ESM's mandate defined in the current Treaty, as the credit line from the ESM to the SRF would constitute interinstitutional lending while the current Treaty only allows the ESM to lend to a member state. Enhancing the role of the ESM in crisis management is another topic of reform. Given that the current ESM Treaty is not explicit on its preventive function, the reforms are likely to develop it by allowing the ESM to join the European Commission for economic surveillance over the 19 euro area members based on the ESM's complementary technical expertise.¹ In addition, some proposals also support the idea of the ESM providing liquidity to smooth business cycles, whereas the current Treaty confines ESM interventions to tail and systemic shocks.

Other RFAs may face similar situations in the future when their mandates need to keep pace with the changing business needs in their regions.

3.2 An RFA's Tool Kit Should be Tailored to Regional Needs

An RFA's mandate largely conditions the tool kit it will have to fulfill it. Ideally, if an RFA's mandate aims to address regional vulnerabilities, its tool kit, lending policies, and financing terms should best accommodate those regional needs. This would also enhance RFAs' complementarity vis-à-vis the global crisis fighter, the IMF.

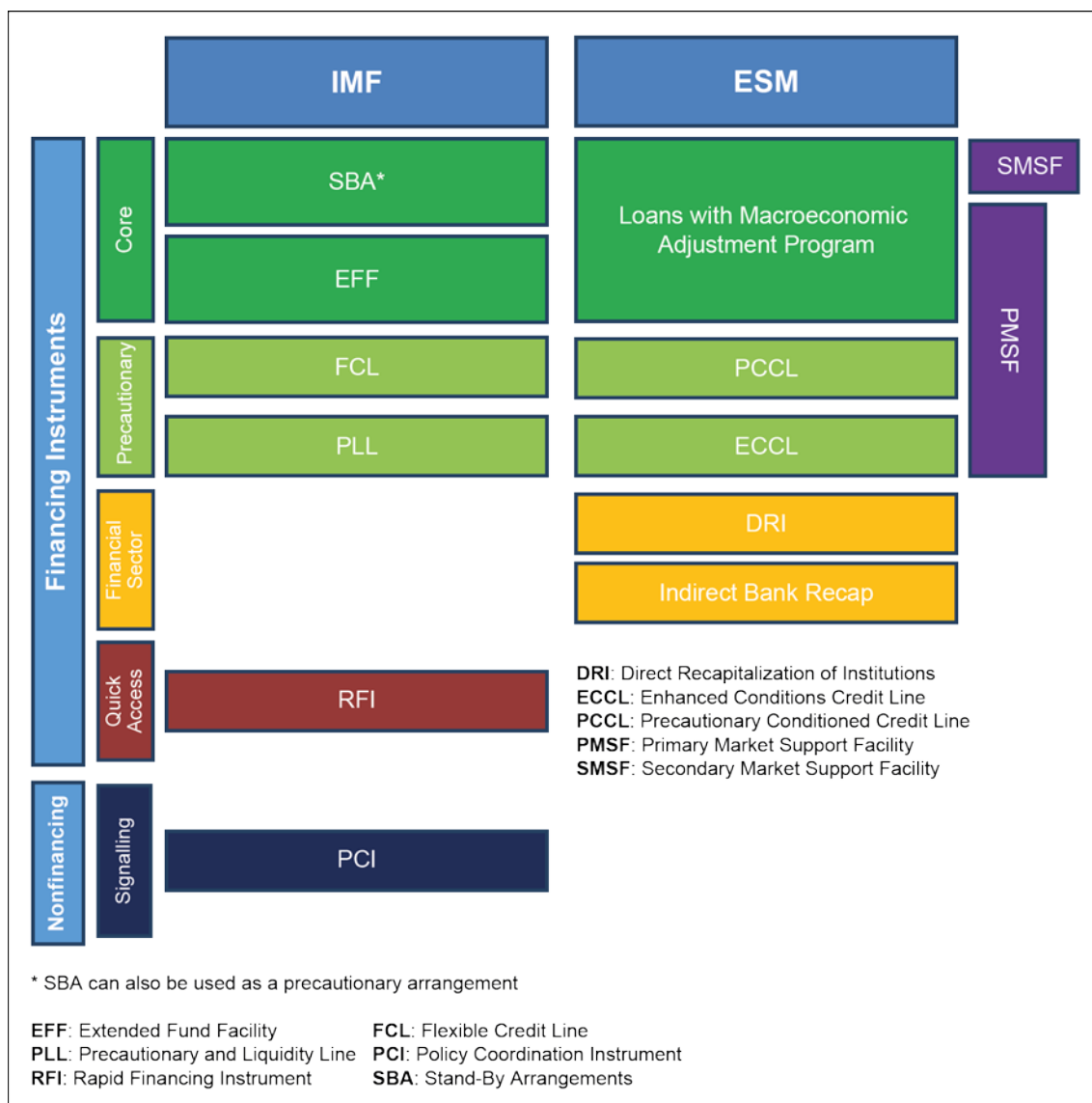
Figure 4 gives an overview of the ESM tool kit compared with that of the IMF under the General Resources Account (GRA) to highlight regional specificities in Europe. The ESM's loan facility, the so-called "Macroeconomic Adjustment Program," constitutes its workhorse instrument and is similar to the IMF's SBA and its Extended Fund Facility (EFF). The objective of these loans is to provide emergency resources to fill a budgetary financing gap in the requesting member state in the short run in exchange for policy corrections. In the long run, the loan facility would enable its user countries to regain market financing and keep their public debt sustainable. In addition, the ESM also has two precautionary instruments, the Precautionary Conditioned Credit Line (PCCL) and the Enhanced Conditions Credit Line (ECCL), which mirror the IMF's Flexible Credit Line (FCL) and Precautionary and Liquidity Line (PLL). Precautionary financial assistance is aimed at supporting sound policies and preventing crises by allowing ESM members to secure a credit line before they face major financing difficulties in capital markets. This type of instrument is particularly important if an RFA wants to send positive market signals to enhance investors' confidence or to prevent potential crisis spillovers to stand-by countries. The current reforms of the ESM tool kit are aimed in particular at enhancing the predictability and attractiveness of its precautionary instruments.

Given that the ESM's mandate has a strong focus on financial stability, it has been equipped with specific financial-sector and market-oriented tools. For instance, it can provide a loan to a member's government specifically for banking sector recapitalization. This is by nature a sectoral lending instrument that the IMF does not have. With this instrument, the ESM provided a €100 billion financial envelope to Spain for banking reform, out of which €41.3 were actually disbursed between December 2012

¹ The reforms are subject to political decisions at the highest level in the EU. However, the European Commission and the ESM published a joint position on their collaboration, which touches upon potential new ESM mandates.

and February 2013. This assistance enabled the recipient country to recapitalize while limiting negative spillovers to public finances. There are also policy conditions attached to these loans but they mainly focus on the requesting country’s financial sector, e.g., strengthening financial supervision and corporate governance, establishing domestic laws relating to restructuring and resolution mechanisms, etc. In addition to this indirect bank recapitalization tool, the ESM can use an ultimate weapon – Direct Recapitalization of Institutions (DRI) – in exceptional circumstances. It would enable the ESM to participate directly in the capital of a bank whose viability needs to be restored. This tool is aimed at severing the feedback loop between the balance sheet of the sovereign government and that of banks.

Figure 4: IMF-ESM Tool Kit Comparison



Source: the author’s depiction.

The ESM also has two side instruments as highlighted in purple in Figure 4: primary and secondary market support facilities. Instead of providing a standard loan, the ESM may purchase debt securities issued by a beneficiary member country in the primary or secondary market. The advantage of this market operation over direct loans is that it allows the beneficiary member to maintain or restore its relationship with the investment community and therefore reduce the risk of failed auctions in crisis times. These two complementary tools also reflect the particular attention that the ESM pays to its members' market access.

The ESM's lending policies and the financial terms of its assistance also mirror regional specificities. Table 1 demonstrates that ESM facilities have in general lower financial costs and much longer maturities than the IMF's GRA instruments. The ESM governing bodies specifically selected the longer maturities to accompany the beneficiary members while they implemented longer-term structural reforms. These financing features, which are also documented in Corsetti, Erce, and Uy (2017), demonstrate a strong regional solidarity. Low-cost and long-term EFSF/ESM loans to Greece save the country about €12 billion per year, or 6.7% of its GDP, compared to market financing (see ESM 2019). Moreover, all ESM instruments provide assistance in euro, the common currency. This underlines that the instability the ESM is created to deal with results from intraregional financial and fiscal problems, rather than from foreign-currency liquidity shortages.

Table 1: The Financing Terms of IMF SBA and EFF vs. ESM Loan Facility

| | Loan Size | Base Rate | Margins/Surcharge | Repayment Period |
|-----|---|--|---|--|
| IMF | Normal access: up to 145% (annually) and 435% (cumulatively in a program) of a country's quota | | Basic margin: 100bp | SBA: five years maximum |
| | Exceptional access: no explicit upper limit, conditional on the IMF's forward commitment capacity The IMF SBA for Greece in 2010 reached 3212% of the country's quota | SDR rate (1.1% as of 31 December 2018) | Surcharge: 200 bp on credit outstanding > 187.5% of quota Additional 100 bp if repayment period exceeds 36 months (SBA) or 51 months (EFF) | EFF: ten years maximum |
| ESM | Flexible approach: no preset upper limit | Cost of funding (0.61% as of 31 December 2018) | Loans: 10 bp Indirect bank recapitalization: 30 bp Possible penalty interest on overdue amounts | Flexible approach: no preset rules Effective average maturities range between 12.5 and 42.65 years |

Source: the author's calculation based on IMF and ESM pricing policies and Cheng, Miernik, and Turani (2019).

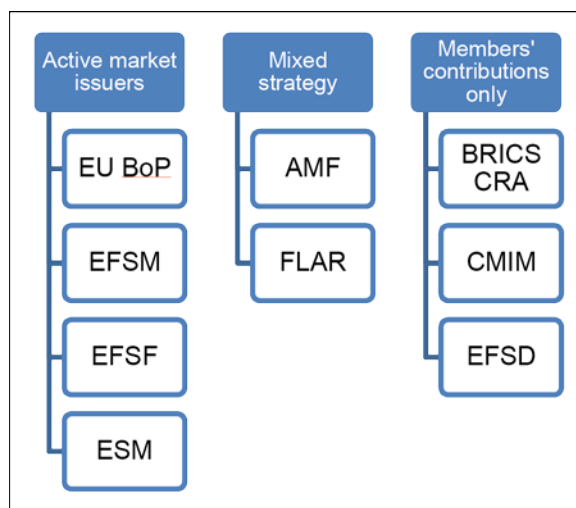
Based on the European experience, the CMIM can consider three issues pertaining to tool kit design. First, the CMIM currently possesses two instruments: a stability facility and a precautionary facility. Both instruments are aimed at providing dollar liquidity to a member state hit by a balance-of-payments crisis. Given the large-scale cross-border bank flows and growing importance of FinTech financing, the ASEAN+3 region may need to tackle financial stability issues directly in the future. Moreover, the CMIM financing is based only on US dollars. This reflects the dominance of the US dollar in regional trade and financial transactions. Given increasing regional financial integration (ADB 2018)

and the broader use of two regional currencies, the renminbi and the yen, CMIM decision-makers could also consider denominating part of CMIM resources in one of the regional currencies to reflect strengthened regional economic linkages among ASEAN+3 countries. In this regard, AMRO published a joint research study in 2019 that explores the plausibility of local currency contribution to the CMIM (Sussangkarn et al. 2019). Finally, as some CMIM resources can only be mobilized jointly with an IMF program, one specific issue is the compatibility of the CMIM repayment period, which needs to reflect the IMF’s preferred creditor status and financial assurance policy for cofinanced programs. The ASEAN+3 Finance Ministers and Central Bank Governors decided in 2018 to extend the length of the CMIM supporting periods under the IMF-linked portion (see AFMGM 2018). Cheng et al. (2018) shed light on the potential complementarity in IMF and RFA instruments in terms of repayment periods. Cheng, Miernik, and Turani (2019) argue in particular that ESM could complement the IMF’s workhorse instruments with its long-term instruments whereas the CMIM stability facility, especially the delinked portion, could provide a quick first line of defense against a liquidity shock of a limited scope.

3.3 The RFA’s Mandate also Conditions Its Funding Strategy

Another crucial issue that RFA shareholders need to decide upon is how to fund the RFA’s assistance programs. Cheng and Lennkh (2018) studied the typology of RFAs’ financial structures, as shown in Figure 5.

Figure 5: Diverse Funding Strategies among RFAs



Source: the author’s depiction based on Cheng and Lennkh (2018).

The European RFAs finance their programs exclusively by issuing supranational bonds and bills. EU BoP and EFSM funding activities are backed by the EU budget. The EFSF and ESM’s fundraising capacity is ensured by the very strong political and financial support of their respective shareholders. The EFSF’s debt issuance benefits from an irrevocable and unconditional guarantee from 13 euro area member states.² Total guarantees amount to 165% of the EFSF’s outstanding securities,

² Note that Cyprus, Greece, Ireland, and Portugal ceased acting as EFSF guarantors because they borrowed themselves from the facility. They are expected to return as guarantors once their ratings improve and are beneficial to the EFSF’s overall ratings.

ensuring over-collateralization of the EFSF's debt issuance. As of November 2018, the Aaa-rated member states (Moody's rating scale) contribute to 35.5% of total guarantees, covering nearly 57% of the EFSF's issues. The ESM possesses even stronger capital buffers thanks to the capital structure provided by its 19 members. The mechanism has €80.55 billion of paid-in capital and €624.25 billion of callable capital. The paid-in capital, together with the retained earnings in a specific reserve fund, cannot be lent to members but must be invested in high-quality securities. The mechanisms that allow calling for additional capital serve as a strong buffer to protect ESM bondholders (Article 9 of the ESM Treaty).

For funding activities, the ESM uses capital market and money market instruments. Capital market tools include benchmark bonds with maturities of one to 45 years. The ESM may hold its own bonds for a limited amount, to raise additional funding by selling them on the secondary market or by using them as collateral in the secured money market. The ESM may also issue promissory/registered notes. The ESM issues bills through regular auctions and may engage in unsecured money market transactions. Transactions may be conducted overnight, on a rolling basis, or for tenors of up to one year. The ESM may also issue commercial paper and money market promissory notes, as well as engaging in repo transactions. It has established liquidity lines with ESM members' Debt Management Offices and a network of credit lines with private banks. Overall, ESM securities are very safe and liquid and the Basel Committee on Banking Supervision has designated ESM securities as Level 1 High-Quality Liquid Assets, which are therefore included in the list of entities receiving a 0% risk weighting under Basel II.

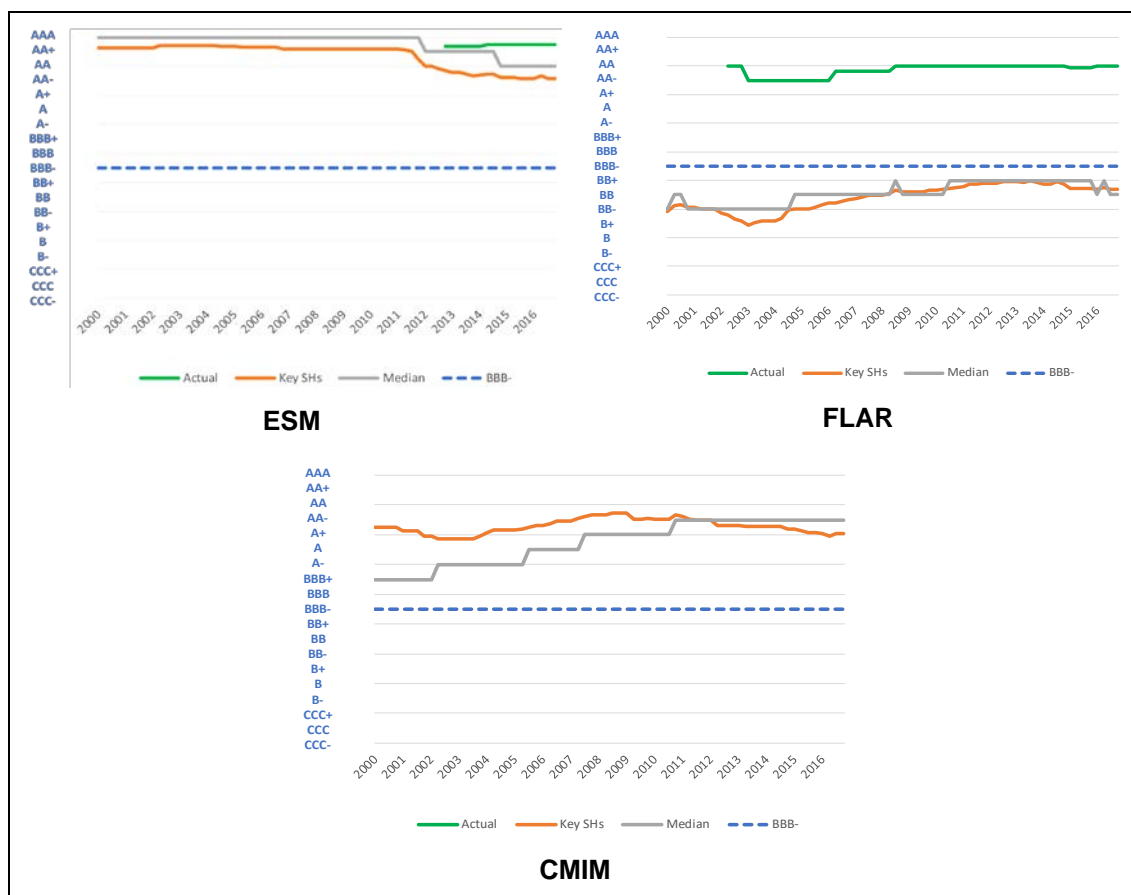
In contrast to the European RFAs, the CMIM and the BRICS Contingent Reserve Arrangement can only use their member states' contributions for assistance programs. The contributions for these two arrangements are based on the financial commitments among the participating countries' central banks, and are not paid in with the RFA. While the EFSF also bases its lending only on member states' contributions, \$3.059 billion is paid in out of a total subscribed capital of \$8.153 billion. This particular feature of the swap line-based RFAs casts doubt on the predictability and swiftness of their liquidity provision in times of crisis, thereby motivating regular test runs to ensure that the funds can be pooled from different central banks and channeled to the central bank of the country requesting assistance.

To enhance predictability in the future, CMIM members could consider making part of the total \$240 billion stand-by and immediately available, for instance the "delinked portions," i.e., 30% of CMIM resources that can be mobilized without an IMF program. This is equivalent to \$72 billion. The paid-in contributions could send a stronger signal to the market on the readiness of the CMIM to deal with future shocks. In noncrisis periods, the paid-in resources can be invested in highly secured and liquid assets, which could also constitute an additional income stream for the ASEAN+3 financial backstop.

Were the CMIM to consider tapping financial markets in the future, member states would need to think about a few design questions, for instance the capital structure, the relative weight between paid-in and callable resources, and the interaction with rating agencies. Cheng and Lennkh (2018) put forward a dynamic relationship between the creditworthiness of member states, their relative contribution to the RFA, and the split between paid-in and callable capital. On the one hand, the higher the paid-in capital – which represents a direct transfer from the member states to an RFA – the larger the borrowing capacity of an RFA, and thus the higher its financial assistance capacity. On the other hand, the larger the callable capital, especially when it is associated with the highest-rated member states, the higher member states' support is perceived by the markets, and the higher the creditworthiness the RFA possesses to raise funds on its

own. Figure 6 compares the rating history based on RFA shareholder support between the ESM, FLAR, and the CMIM. Given the share of the Plus Three countries (Japan, the Republic of China (PRC), and the Republic of Korea), the CMIM could potentially benefit from a relatively strong support rating. The example of FLAR also shows that a good management and an excellent repayment record – no FLAR member states have ever defaulted on FLAR’s credit – could raise an RFA’s credit rating, even several notches above that of the supporting membership.

Figure 6: Rating History Based on RFA Shareholder Support



Note: *Actual* gives the actual rating of an RFA if this exists. *Key SHs* refers to Fitch’s *Average Key Shareholders* metric, which measures the capital-key weighted sovereign rating of an RFA’s largest shareholders whose cumulative total capital contribution exceeds 50%. *Median* refers to Moody’s metric *Median Shareholder Rating*, which indicates the rating of the median shareholder according to the capital key.

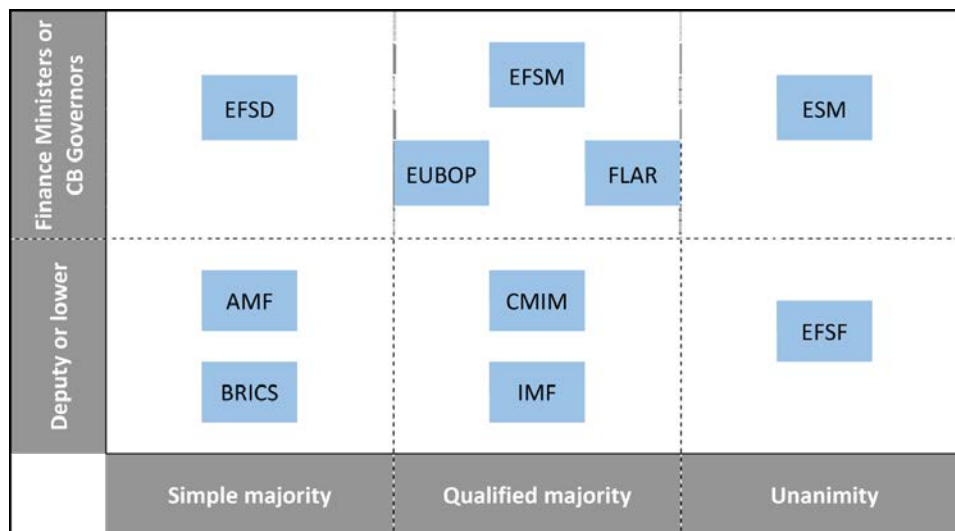
Source: Cheng and Lennkh (2018).

3.4 Governance Structure and Decision-making

Finally, governance structure and the decision-making procedure will directly affect an RFA’s operations. The governance structure not only reflects the balance of power among the member states, but it will also condition the swiftness of liquidity provision and conditionality design, wherever that is relevant. Figure 7 maps out the governance structure and voting procedure in different RFAs as regards the decision to grant an assistance program. The IMF was introduced as a reference point. The ESM seems to have the most demanding decision-making structure as granting financial assistance requires the unanimity of 19 euro area finance ministers. In some members, finance

ministers must also submit the prepared financial assistance program to members of their national parliaments for approval.

Figure 7: Mapping IMF and RFAs' Governance Structure



Source: the author's depiction.

The ESM's highest decision-making organ is its Board of Governors (BoG), which consists of finance ministers of the euro area member states. The European Commissioner for Economic and Monetary Affairs and the ECB President may participate as observers. The BoG meetings are chaired by a Chairperson, who has been the President of the Eurogroup since the inception of the ESM. The BoG makes decisions regarding financial assistance, capital increases, ESM membership, and the Managing Director's appointment. The most important decisions, including whether to provide stability support to an ESM member state, the choice of instruments, conditions, and terms of such support, require mutual agreement among Governors. In a number of other areas highlighted in Article 5 of the ESM Treaty, the BoG makes decisions by a qualified majority, defined as 80% of the votes cast with voting rights equal to the number of shares allocated to each country. In addition, each Governor in the ESM BoG appoints one Director and one alternate Director that form the Board of Directors (BoD). The BoD works based on the competences delegated by the BoG and ensures that the ESM is run in accordance with the ESM Treaty and the by-laws.

The Managing Director, who is nominated by the BoG, chairs BoD meetings and conducts the day-to-day business of the ESM with assistance from the ESM Management Board. The Managing Director also serves as the ESM's chief of staff and legal representative. The current ESM Managing Director is Klaus Regling, nominated in 2012 for an initial five-year term and reappointed for a second term from 8 October 2017.

As regards the decision-making procedure for the ESM to grant financial assistance, the ESM Evaluation Report (Tumpel-Gugerell 2017) sheds light on the extensive involvement of ESM/EFSF governing bodies in elaborating decision criteria and in setting up program governance frameworks. In part, this was because crisis resolution in the currency union was a new experience for euro area members; they needed to establish rules and guidelines as the crisis unfolded. After policy makers decided that the ESM should serve as a backstop for the Banking Union's Single Resolution Fund,

one key technical discussion was to put in place appropriate procedures to allow for swift and efficient decision-making to fit the timeline of bank resolution, whilst respecting national constitutional requirements. Disbursements under the common backstop are proposed to be approved by a unanimous decision of the ESM Board of Directors guided by a number of criteria.

Compared with the ESM, the CMIM governance structure has slightly softer voting rules for granting a program (i.e., a qualified majority), and decision-makers are at deputy ministerial level. This does not necessarily mean that decisions on financial assistance would be made more easily given greater heterogeneity across the ASEAN+3 membership. FLAR provides a completely different experience as their members have equal voting power and they decide with a 75% qualified majority. The FLAR Executive President can approve the use of liquidity and contingency credit lines; only the balance-of-payments support would require the approval of the Board of Directors, which is composed of Central Bank governors. This governance structure helps FLAR to react to regional shocks promptly. In fact, as the institution has often provided “bridge financing” to its members while waiting for a fully fledged IMF program with a bigger financing envelope and conditionality (see Cheng, Giraldo, and Hamel 2018), providing liquidity promptly is a FLAR design feature.

The CMIM faces one complication, which is the separation between its crisis resolution resources and the entity supporting the implementation of the CMIM, i.e., AMRO. As an international organization, AMRO has provided support for the development and continuous enhancement of the CMIM by contributing to the CMIM’s operational guidelines, conducting surveillance, enhancing the Economic Review and Policy Dialogue (ERPD) Matrix, and organizing CMIM test runs. AMRO has also provided intellectual and administrative support to strengthen further the CMIM by establishing the CMIM’s conditionality framework and facilitating collaboration between the CMIM and its peer institutions.

4. CONCLUSION AND RECAP OF POLICY RECOMMENDATIONS

Six years have passed since the EFSF – the ESM’s predecessor – was created and its first financial assistance program was agreed. Since Greece exited the ESM program in August 2018, all euro area country programs – in Ireland, Portugal, Spain, Cyprus, and Greece – have successfully terminated and all program countries have started post-program monitoring. The ESM will accompany them for a long period until the full repayment of ESM funds given their very long maturities. The past six years also witnessed the institutional development of the euro area crisis resolution mechanism. From the crisis resolution ATM for the euro area, the ESM’s role has evolved quickly.

The ESM’s institutional development sheds light on a number of relevant policy issues for the CMIM to consider for its own evolution. Most importantly, the CMIM could re-examine its mandate against region-specific shocks, which may have changed in nature since the Asian financial crisis 20 years ago. For instance, demographic changes and climate change may have raised new challenges for public finance management and rapid expansion of FinTech flows may have created new sources of capital flow volatilities. These changes in turn may encourage the CMIM to think about new instruments, which could necessitate new funding strategies. For instance, member state governments in the region may need longer-term financing to tackle structural issues. In this case, the CMIM may think of developing a credit line similar to the IMF EFF or the ESM loan with a macroeconomic adjustment program. From this perspective,

CMIM pooled resources based on swap commitment among the participating central banks may not be the most appropriate. Some part of the committed resources may need to be paid in to ensure this longer-term support for structural reforms. To deal with liquidity shocks of a limited scope, the CMIM could think about the feasibility of further developing a regional liquidity instrument, as proposed by the G20 Eminent Persons Group. One way forward is to enhance the access policy and predictability of the CMIM delinked portions. Cheng, Miernik, and Turani (2019) show that the delinked 30% of CMIM resources could already provide a financing envelope similar to the IMF's Short-term Liquidity Swap proposal for eight out of 14 jurisdictions covered by the CMIM. CMIM member states could also consider strengthening the link between CMIM resources and additional bilateral swap lines that exist in the region.

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