

Countries under Adjustment Programmes: What role for the ECB?

IN-DEPTH ANALYSIS

Abstract

Providing 'technical assistance/advice' on programmes for countries under financial stress is well within the mandate of the European Central Bank (ECB). Being fully part of the Troika, however, is a different role. Formally the ECB does not participate in the 'decision-making' on programmes (decisions are taken by the Finance Ministers – and the IMF). However, the ECB is part of the 'decision-shaping' process. These two roles have often been confused. The ECB should interpret its formal role in future ESM (European Stability Mechanism) programmes as narrowly as possible. Providing advice but avoid taking part in the operational work of programme surveillance. The ECB should de facto leave the Troika.

At any rate, future incidents like the Italian or Spanish letters will be superseded by the OMTs (outright monetary transactions) and an Irish-type situation would be shaped by the legal framework of the Bank Recovery and Resolution Directive (BRRD) and the potential funding from the Single Resolution Fund (SRF).

An additional issue for the ECB is internal coherence: Its six-member Executive Board manages the participation in the Troika, monetary policy is decided by the Governing Council and banking supervision is under the Supervisory Board, separated in principle by Chinese walls from the (rest of the) ECB.

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AUTHOR

Daniel GROS, CEPS

RESPONSIBLE ADMINISTRATOR

Dario PATERNOSTER
Policy Department A: Economic and Scientific Policy
European Parliament
B-1047 Brussels
E-mail: Poldep-Economy-Science@ep.europa.eu

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ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its monthly newsletter please write to:
Poldep-Economy-Science@ep.europa.eu

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LIST OF ABBREVIATIONS

AQR	Asset Quality Review
BRRD	Bank Recovery and Resolution Directive
ELA	emergency liquidity assistance
ECB	European Central Bank
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
GC	Governing Council (of the Eurosystem)
OMT	Outright Monetary Transaction
PSI	Private Sector Involvement
SMP	Securities Markets Programme
SRB	Single Resolution Board
SRF	Single Resolution Fund
SSM	Single Supervisory Mechanism

EXECUTIVE SUMMARY

- The participation of the European Central Bank (ECB) in the so-called Troika of institutions that manage country adjustment programmes has aroused a lot of political controversy. It is difficult to see why an institution whose task is to ensure price stability for the euro area as a whole should be involved in managing a programme targeting fiscal adjustment and structural reforms in individual member countries.
- It should be borne in mind that when the adjustment programmes started (for the first times in 2010-11) in crisis-hit countries, the entire euro area was facing deep market turbulence and the ECB seemed to be the only institution capable of dealing with the problems at hand. This is important in order to judge the role of the ECB in the country programmes.
- At that moment, it seemed natural to ask the ECB to provide 'technical assistance' and 'advice' concerning the programmes for countries that needed emergency financing. Since the financial stability of the entire euro area seemed at stake, it seemed to fit the mandate of the ECB.
- Being fully part of the Troika is different, however, than providing technical advice. These two different roles have often been confused. The ECB does not participate in the formal decisions concerning the programmes. Decisions on conditions, financing envelopes, etc. are taken by the Finance Ministers (and the IMF). However, the ECB has been very much part of the 'decision-shaping'.
- During the acute phase of the euro crisis, the crucial role of the ECB might have been unavoidable, but in the future, the framework will be different. Incidents like the Italian or Spanish letters will not occur again. The Securities Markets Programme (SMP) has been replaced by the outright monetary transactions (OMTs), which require a European Stability Mechanism (ESM) programme. An Irish-type situation would be managed within the legal framework of the Bank Recovery and Resolution Directive (BRRD) and with potential funding from the Single Resolution Fund (SRF).
- Going forward, the ECB should interpret its formal role in ESM programmes as narrowly as possible. It should limit itself to providing advice and avoid any involvement in the operational work in programme surveillance.
- This already applies to the new programme for Greece. From now on, the ECB should avoid taking part in teams that discuss details of fiscal policy or the many other policy areas (labour markets, competition policy, etc.) covered by the conditionality of the programme. If this happens, in the eyes of the public, the ECB would have, de facto, left the Troika.
- Of course, the ECB retains a legitimate interest in the stability of the banking system of every member state. In this context, it may be faced with a problem of internal coherence. Banking supervision is the responsibility of the Single Supervisory Mechanism (SSM), separated in principle by Chinese walls from the (rest of the) ECB. This implies that any problems in this area should be left to the Supervisory Board (of the SSM), one member of which is also part of the Executive Board that manages the participation of the ECB in country programmes.

1. INTRODUCTION

Since 2010, the European Central Bank (ECB) has been part of the so-called Troika of institutions (with the European Commission and the IMF) that has managed the adjustment programmes of countries that have been hit the hardest by the crisis (Greece, Ireland, Portugal and Cyprus) in exchange for financial support, through different mechanisms, bilateral loans under the Greek loan facility, the European Financial Stability Facility (EFSF) and finally the European Stability Mechanism (ESM).

In this framework the ECB has participated in the design and adoption of the programmes. The stated aim was to re-establish financial stability of crisis countries. Unfortunately, it is impossible to say exactly what the extent of the involvement of the ECB has been (there is only anecdotal evidence, as suggested in the short literature review below). However, there is a widespread perception that the ECB's role has been of crucial importance in many instances, even if formally its role was only to provide 'advice'.

Much of the complexity of the matter comes from the fact that the ECB has also acted as a 'quasi' lender of last resort outside country programmes when it bought Italian and Spanish government bonds in 2011. Although these purchases were made under the Securities Markets Programme (SMP), whose official purpose was to repair the monetary transmission mechanisms, de facto the ECB tried to extract reforms from the countries in question in exchange for intervention on the bond markets. These 'conditions' were put in letters written by the President of the ECB to national governments. The letters themselves were not made public, but were immediately leaked to the press.

All of this has provoked strong criticism of the ECB, which is seen as having interfered too much in matters of national sovereignty.

One difficulty, which is also the reason for different views on the role of the ECB, is that, in a financial crisis, it is impossible to completely separate financial and fiscal matters. Moreover, during a crisis, decisions have to be taken on the spot, under market pressure, and with limited information. It is thus very difficult to second-guess the decisions taken at the time.

The main focus of this short contribution is thus how a similar crisis might play out in the future. A first point that one has to keep in mind is that future banking problems will be resolved under a completely different framework, which includes the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF). These elements of the (still-incomplete) Banking Union will transform the way in which financial stability is addressed and (national) banking crisis will be dealt with. Under the BRRD, bail in will be mandatory and the SRF will be able to provide substantial financing. Moreover, the Single Supervisory Mechanism (SSM) will possess the required information and expertise to deal with banking problems. This already means that the rationale for any involvement of the ECB must change.

Moreover, the term ECB is often used too loosely. From the outside the ECB constitutes one monolithic body. But in reality there are (now) two major areas of action, i.e. monetary policy and banking supervision, and three separate decision-making centres within the conglomerate ECB:

1. Governing Council (25 members, of which 16 are voting national central bank governors)
2. Executive Board (6 members)
3. Supervisory Board (25 members, of which 19 are national supervisors)

The existence of these three separate bodies poses several problems of internal coherence for the ECB, as enumerated below:

The Governing Council is in principle the supreme decision-making body. It manages monetary policy, but not directly the participation of 'the ECB' in the Troika, about which it is informed by the Executive Board. The Executive Board manages the participation in the Troika.

The Supervisory Board (of the SSM) in principle drafts decisions related to banking supervision for the Governing Council. In practice, the 'non-objection' procedure¹ ensures that decision-making on banking supervision belongs to the Single Supervisory Mechanism.

The SSM did not exist at the time the country programmes were designed and implemented. The latest Greek programme is the only exception. In future ESM programmes, there will no longer be the pressing need to involve the ECB (or, rather, its Executive Board) in detailed programme design and assessment.

In this respect the future is likely to be very different from the past. The Irish approach (namely to save banks by increasing public debt) is unlikely to return in this form. Similarly for the Italian and Spanish case. Given that the SMP has been superseded by the Outright Monetary Transaction (OMT) programme, there will be no reason for the ECB to send a letter to the Prime Minister of Italy (or any other country) with a checklist of reforms to be approved before a certain deadline in order for the central bank to continue buying government securities.

The remainder of this paper is organised as follows. Section 2 provides a brief review of the (scarce) literature on the role of the ECB in adjustment programmes. Section 3 looks briefly at the Irish case as an example of how different (and more difficult) the situation was in 2011. Section 4 then analyses the institutional framework for 'the ECB' in country adjustment programmes (discussing also briefly the implications for the current Greek programme). Section 5 concludes.

2. LITERATURE

While the ECB was formally not part of the decision-making of the adjustment programmes, it has been reported to have played a crucial role, not only through policy advice but also for reasons associated with the fact that it had provided very large amounts of liquidity to the banking sector, modified eligibility standards for collateral and bought sovereign bonds of countries under financial pressure.

There may be an argument that the ECB had a lot at stake at that moment, ranging from the possible financial destabilisation of the entire euro area to the risk of incurring losses on controversial purchases of sovereign bonds and on large liquidity provisions. In that context, potential conflicts of interests could have materialised.

This being said, a fully fledged assessment of the ECB's participation and its degree of involvement in the various programmes is a very challenging task – even ex-post. On the one hand, it is impossible to say how markets would have reacted to different decisions, and on the other hand, due to the lack of reporting on meetings and decisions, it is impossible to assess the role played by each of the institutions within the Troika.

¹ As of January 2015, the Governing Council's responsibilities include, inter alia, the following; "in the context of the ECB's new responsibilities related to banking supervision, to adopt decisions relating to the general framework under which supervisory decisions are taken, and to adopt the complete draft decisions proposed by the Supervisory Board under the non-objection procedure (www.ecb.europa.eu/ecb/orga/decisions/govc/html/index.en.html).

The only possible assessment is one based on anecdotal evidence.

Merler, Pisani_Ferry and Wolf (2012) have collected anecdotal evidence pointing to the fact that the ECB's function in the programme missions in Greece, Portugal and Ireland was mostly limited to the financial and fiscal areas and did not extend to the identification of the financing needs. It appears that the position of the ECB on the fiscal side was typically strong, and supportive of larger fiscal adjustment than warranted by the European Commission or the IMF. On the financial and banking side, it repeatedly supported a strengthening of banks' capital base, urged larger packages for banks, larger funds to protect depositors and argued against involuntary debt restructuring of unguaranteed bonds.

As regards the emergence of potential conflicts of interest, it must be recalled that the ECB had to act under very difficult circumstance, involving important trade-offs, and overall, there is a widespread perception that the ECB's role has been of crucial importance in many instances, even if it formally was only to provide 'advice'. Merler et al. (2012) conclude that there is no clear evidence of such conflict of interest. However, they note, similarly to Whelan (2012), that while the advantages of having the institution in charge of monetary and financial stability participating in the programme are clear, the rationale for it is not.

In particular, Whelan (2012) is critical of the double role played by the ECB, both as a policy maker and as policy advisor to governments in the context of conditional financial assistance received. He argues that being part of the design and monitoring of the programme implementation while not being an official provider of financial assistance confuses the public about the conditionality of the programme and raises concerns of legitimacy.

Overall, Whelan admits that Irish fundamentals in 2010 required a bailout and recognises that the assessment of the ECB in this direction turned out to be correct. Nonetheless he argues that over time the ECB has been building an "embarrassing" track record in pushing governments to request bail-out. Irish officials reported pressures to request a bail-out plan, and some believe the ECB threatened that the liquidity support to banks would be withdrawn otherwise.

Similarly, the (in)famous letter sent to the governments of Italy and Spain by the President of the ECB containing reference to "necessary policy actions" seem to reflect an awkward involvement of the ECB in national politics and fiscal affairs, and can be interpreted as an attempt to extract reforms, possibly designed in the context of a bailout programme.

3. FISCAL IMPLICATIONS OF FINANCIAL STABILITY: THE CASE OF IRELAND AS A PRIME EXAMPLE

The ECB had to resort to many 'unconventional' policy measures after the start of the global financial crisis in 2008. In the initial phase of the crisis, its policy actions were clearly addressed to the euro-area financial system as whole. However, this changed when the financial crisis mutated into the euro crisis and nationally differentiated risk premia arose, and some governments started to lose access to market financing.

At that point, the ECB faced a fundamental problem: it was trying to conduct a monetary policy for the entire area while financial markets were separated along national lines, which made policy ineffective. The ECB thus argued that the monetary policy transmission mechanism was broken in several countries and that this was a legitimate concern. There was a valid reason why the ECB had to be involved in individual countries, although its mandate concerned the euro area as whole. But the key difficulty in judging the role of the ECB during such turbulent times is that sometimes the indirect (or unintended) impact of decisions can be much more important than the direct one.

The Irish case illustrates this point very well. A total amount of €64 billion was injected into the Irish banks. The Government borrowed €12 billion, another €21 billion came from the National Pensions Reserve Fund (NPRF) and an additional €31 billion came in the form of Promissory Notes (PNs). This would have given Ireland a world-record budget deficit of more than 30% of GDP in 2010. However, the impact on both deficit and debt was less than the total cost of the bailout because the €21 billion of the recapitalisation that came from NPRF were in fact not borrowed and hence were not included.²

The debates about the decision to fully pay out unsecured bondholders of Irish banks usually focus on the amount that the Irish government would have saved if this had not been done. This amount has been estimated at around €3-4 billion by the ECB,³ which is not insignificant relative to the Irish economy (about 2% of GDP) and total Irish public debt (the percentage is somewhat lower since public debt exceed annual GDP in Ireland). But by itself, the expenditure saved would not have decisively changed the outlook for Irish debt sustainability. Moreover, since part of the debt was held by Irish entities, including Irish pension funds, the burden of a 'private-sector involvement' (PSI) would have fallen, at least partially, on Irish citizens anyway.

At that time, the legal procedure to be followed in order to contemplate action vis-à-vis bond-holders would have been somewhat difficult as the framework for restructuring failing banks and bailing-in bond-holders had not been developed yet (the BRRD came only years later). A formal bankruptcy might have been required to achieve any PSI. But even apart from the legal uncertainties, it remains difficult to provide a definite judgment on this episode because effects on market confidence can never be anticipated with accuracy.

The ECB continues to argue that bailing in the senior unsecured bondholders would have undermined investor confidence in the Irish government and further aggravated financial market tensions throughout the entire euro area (and possibly beyond). Even with the benefit of hindsight, there is no way one can determine the validity of these arguments with any precision.

One available option at that time could have been to use collective action clauses and try to achieve a 'voluntary' private-sector contribution in the form of a restructuring of these bonds, including perhaps a small partial haircut and a substantial extension of maturities.

² See McArdle (2012) for a comprehensive assessment of the matter.

³ See McArdle (2012, p.13).

But it is a matter of judgment whether the impact of such an approach on financial markets would have been so severe that in the end the Irish government would have been worse off. One has to defer to the ECB as the key institution responsible for financial stability.

In this perspective, the issue that should have been raised at the time is whether it was appropriate to ask the Irish government to assume the burden of safeguarding the stability of the euro-area financial system. To the extent that the 'advice' of the ECB not to bail in senior bond-holders was based on concerns for the stability of the entire euro area, one should have found a way to compensate the Irish government for its contribution.

Such a problem should not arise again in the future since the SRF would provide the financing for a restructuring, thereby avoiding a formal bankruptcy. In principle a bail-in of senior bond-holders would be decided under the BRRD only on the basis of the losses incurred and the capital required to create a viable new bank.

4. THE ROLE OF THE ECB IN COUNTRIES UNDER PROGRAMMES

4.1 The Past

The legal basis for the involvement of the ECB in adjustment programmes has changed slightly over time, from the first Greek Loan Facility, the EFSF and finally the ESM. However, the legal texts are vague and leave room for interpretation. The current legal framework is given by the ESM Treaty which calls upon the ESM Board of Governors "to give a mandate to the European Commission to negotiate, in liaison with the ECB, the economic policy conditionality attached to each financial assistance, in accordance with Article 13(3)".⁴

The key expression here is "in liaison with", which can be interpreted in a broad fashion. The central practical aspect, which made the ECB part of the Troika, was its participation in missions to programme countries. ECB staff participated apparently in most meetings, even if the subject matter was far removed from the ECB's core (and exclusive) competence, namely monetary policy and financial stability.

The justification given by the ECB is usually that price stability depends also on financial stability and that tough labour market and other reforms are necessary to regain investor confidence. However, this is clearly 'mission creep'. All economic policy actions might have some influence on investor confidence or some indirect impact on price stability.

It is of course possible to argue that the details of Greek labour laws, or the regulation on taxi drivers in Athens, have an impact on the success of the Greek adjustment programme and thus on the stability of the euro-area's financial system and thus finally on price stability. But if one follows this line of argument to its extreme, no policy domain lies outside the purview of the ECB.

The combination of 'mission creep' and the choice to decline responsibility for decisions is apparent in the reply of the ECB to the European Parliament:

The advice provided by the troika (including on reform priorities) aims at achieving healthy public finances, financial stability, competitiveness and sound economic policies and thereby at creating the conditions for sustainable growth and job creation in the programme countries. Decisions on granting the financial assistance, the economic policy conditions attached to the assistance and quarterly disbursements are taken by the ECOFIN Council under the EFSM Regulation, by the

⁴ <http://www.esm.europa.eu/about/legal-documents/ESM%20Treaty.htm?lang=-en>

EWG/guarantor Member States under the EFSF Agreement and by the ESM Board of Governors under the ESM Treaty.⁵

The key issue is thus that publicly the ECB has been very much part of the process, appearing to have the same footing as the other members of the Troika. The very term, troika, already suggests that its three members have equal influence and that the consent of the ECB was sought for all major decisions.

Today the ECB argues that it only gave 'advice' and that Finance Ministers took all the decisions, but during the time the programmes were running, the ECB has seldom emphasized this aspect in public. Members in the Governing Council were usually careful to use the term advice in describing the activities of the ECB, but the overall impression they were giving was that the ECB played a full part in the process and had developed views on all aspects of the overall programme design.

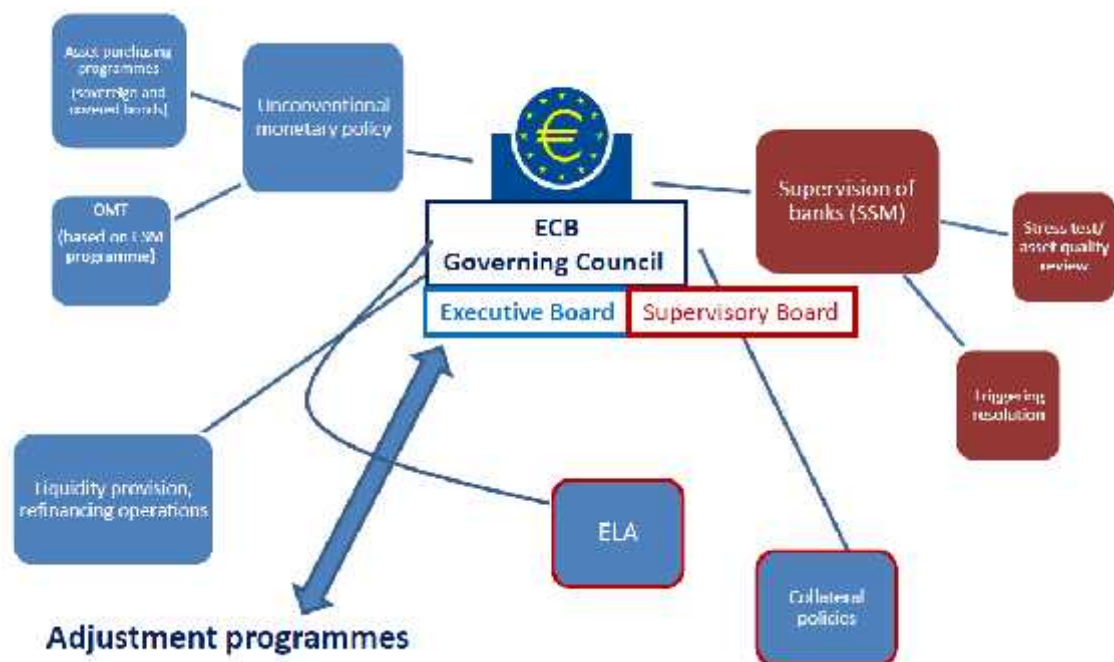
4.2 The Future

The legal framework for the involvement of the ECB in the programmes has been fixed in the ESM Treaty, but the future will be different from the past as already mentioned above. The Italian and Spanish-type letters to national authorities will no longer have any justification. The OMT requires an ESM programme (on which the ECB will provide 'advice'). The Ireland-type banking problems will also play out differently, as shown above (this also applies, of course, mutatis mutandis to the cases of Spain, Portugal and Cyprus).

But going forward, the problem of internal decision-making, and hence accountability, will become even more important.

The term ECB is often used too loosely. When a country is under financial distress, there are many areas and situations in which the ECB can be called upon to act.

Figure 1. ECB potential involvement in countries under financial stress



Source: Own elaboration.

⁵ See www.ecb.europa.eu/pub/pdf/other/140110_ecb_response_troika_questionnaireen.pdf

As illustrated in Figure 1, these can belong to the two main areas of action of the bank, namely monetary policy and supervision of banks. While in principle the two are separated, in practice there are decisions that can influence both (e.g. collateral policy and ELA) and such decisions are taken within different bodies.

There are (now) three separate decision-making centres within the 'conglomerate' ECB:

1. Governing Council (25 members, of which 16 are voting national central bank governors, theoretically the supreme decision-making body)
2. Executive Board (6 members)
3. Supervisory Board (25 members, of which 19 are national supervisors)

The existence of these three separate bodies poses a problem of internal coherence for the ECB. The Governing Council is in principle the supreme decision-making body. It manages monetary policy, but not the participation of 'the ECB' in the Troika, about which it is only informed by the Executive Board. The Executive Board manages the participation in the ESM programmes.

The Supervisory Board (of the SSM) in principle only drafts decisions for the Governing Council. But in practice the 'non-objection' procedure ensures that the de facto decision-making body on banking supervision belongs to the Single Supervisory Mechanism.

The SSM did not exist at the time the country programmes were designed and implemented. Furthermore various parts of the ECB will participate in the decision-making and shaping of the Single Resolution Board. The ECB (presumably meaning the Executive Board) has to be invited as an observer to executive sessions of the Single Resolution Board (SRB) and the national supervisory bodies, which have a vote on decisions concerning banks located in their country, are also part of the Supervisory Board of the SSM.

Given this highly complex set-up, it would be very difficult to hold 'the ECB' accountable for its involvement in country programmes (unless it restricts itself to giving advice).

Box 1. The role of the ECB in the third Greek adjustment programme

The current Greek programme is the first (and the only one) to take place under the new institutional framework (but not the BRRD). The role of the 'ECB' must be interpreted with care since the SSM is part of the ECB 'holding' but it is operationally separate following the construction of Chinese walls.

In Greece, the BRRD with its mandatory bailing-in provisions will apply only from January 2016. But application of the BRRD appears inopportune in this case since the bailing-in provisions would hit non-insured deposits, which are mostly the working capital of small- and medium-sized enterprises.

In compliance with Article 13 of the ESM Treaty, the European Commission, in liaison with the ECB, prepared the assessment of the Greek request for stability support in the form of an ESM loan. It foresees that the European Commission, in liaison with the ECB, will have the following tasks:

- "a) to assess the existence of a risk to the financial stability of the euro area as a whole or its Member States;
- b) to assess, together with the International Monetary Fund, whether public debt is sustainable; and

c) to assess the actual or potential financing needs of Greece”⁶

In the document, the reference to the role of the ECB, and its different functions, relates mostly to the assessment of the existence of a risk to the financial stability of Greece. In particular it contains reference to the role played by the Supervisory Board in the framework of the Asset Quality Review (AQR), the actions taken in relation to the ELA, such as its ceiling and the haircut on collateral for ELA, and lastly to the existence of the OMT as a tool to safeguard stability.

The Memorandum of Understanding⁷ contains no specific mention of either the ECB or the Single Supervisory Mechanism.

5. CONCLUSIONS

It is not new that monetary policy decisions may have a fiscal element. However, at the time the Maastricht Treaty was written and ratified, it was assumed that the fiscal implications of monetary policy would be diffuse and of second-order importance. This changed with the financial crisis, forcing the ECB into a delicate position. There is little point in judging the ECB's actions on specific cases, like Ireland, with the benefit of hindsight.

In terms of future ESM programmes, the ECB should limit itself to providing general advice, refrain from going into the details of the programme and should not participate in missions to national capitals. One has to keep in mind that the ECB has three decision-making bodies. The Executive Board has managed the participation in the Troika on its own. The Governing Council, theoretically the supreme body of the ECB, has only be informed ex post. Moreover, the SSM, which is formally part of the ECB, will at any rate most probably be involved in any future ESM programme, as also will the SRB, with funding provided by the SRF.

Given that the ECB is an independent institution, it can in principle exercise broad discretion (within its mandate) in its decisions. But it might be well advised to follow the example of the Federal Reserve, which usually abstains from commenting on the general economic policy of the US government. The independence of the ECB is formally much stronger than that of Federal Reserve. Moreover, the ECB does not face one unified political actor, but many different national governments whose opinions are often at odds with one another, thus providing another, de facto, layer of protection of its independence. But the ECB was granted its full independence so that it could make its monetary-policy decisions without political interference.

The single task (price stability) combined with clear decision-making provide the conditions for the accountability of the ECB. With ambiguous tasks (and responsibilities) and multifaceted involvement in adjustment programmes, it becomes difficult to hold the ECB accountable in this respect. This provides another reason why the ECB should limit its future involvement to giving advice.

⁶ See

http://ec.europa.eu/economy_finance/assistance_eu_ms/documents/2015-07-10_greece_art_13_eligibility_assessment_esm_en.pdf

⁷ http://ec.europa.eu/economy_finance/assistance_eu_ms/greek_loan_facility/pdf/01_mou_20150811_en.pdf

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