assumed to worsen by 0.9 percentage points relative to the baseline scenario, whereas the medium-term five-year impact is 0.5 percentage points). The lower sensitivity in the latter reflects two aspects: (1) lower sensitivity of the deficit to growth shocks in general in the model, and (2) moderate wage, and hence income tax, responses in a Brexit scenario (higher import prices lead to higher consumer prices, which offsets the downward pressure on wages). Second, the Council's scenario is based solely on a growth shock aggregated to the economy-wide level so that the exact nature of impacts from the hard Brexit scenarios on tax headings, cyclical expenditures, and economic behaviour is not considered. Third, the model assumes that the shock takes place in 2019, though the effects could obviously be assumed to take place over the course of 2019–2020, given the current timing.

Box D: Reforms to the European Stability Mechanism (ESM)

Last December, euro area heads of state and government endorsed a set of proposals that may have fiscal implications for Ireland. The goal of the reforms is to enhance the ESM's capacity as a crisis resolution fund—a provider of emergency support programmes—to help the euro area to withstand future crises (ESM, 2018).

The ESM

The ESM is a lender of last resort for countries that lose market access, or are close to losing market access. This is a function that did not exist before the recent crisis and the lack of which was considered a key failing in terms of how quickly and efficiently euro area institutions could respond (Baldwin and Giavazzi, 2015). The ESM was set up in October 2012, has a maximum lending capacity of €500 billion, and finances its activity by issuing bonds and other debt instruments. Its creditworthiness is supported by €705 billion of support from euro area member states: €80.55 billion paid-in capital, and €624.25 billion of callable capital. The callable capital serves as an additional buffer that the ESM can call on member states to contribute as and when necessary. It reinforces the ESM's creditworthiness further should a borrower of ESM funds have to default on a loan payment and should paid-in capital and other reserves prove insufficient to cover losses.

A common backstop to the Single Resolution Fund (SRF)

A key reform to how the ESM operates is the implementation of a common financial backstop for the Single Resolution Fund (SRF) so that it has enough cash to deal with a very big crisis from 2024 at the latest. The SRF is an EU fund for resolving failing banks and is financed by bank contributions. The backstop should mean that the ESM would be able to lend necessary funds to the SRF should the SRF's bank-provided resources prove insufficient to avert major bank failures in future.[18]

It is expected that the SRF bank-provided resources will be around €60 billion (or 1 per cent of deposits covered in the Banking Union) by 2024, while ESM loans available would be about the same size. If the ESM loans were to be used, the SRF would be required to pay back the ESM loan with money from bank contributions within three years (subject to an extension of up to two years). This means that it is intended to be fiscally neutral over the medium term.

The common backstop has several fiscal implications for Ireland:

There are obvious benefits to Ireland arising from the euro area architecture being made more robust. A common concern relating to the last crisis was that individual Member States—by

[18] Loans would have to be mutually agreed by the ESM's Board of Directors, consisting of euro area finance ministry officials, but the plan is that approvals could be made swiftly (in as little as 12 hours).

giving up monetary independence—had stripped away their central banks' role as lender of last resort (De Grauwe and Yuemei, 2013). A lack of guarantees of support from member states allowed liquidity crises to emerge in downturns among crisis countries. These crises were marked by large outflows of liquidity; difficulties in funding debt rollovers at reasonable interest rates; and limited capacity to allow automatic stabilisers to support the economy.

By providing insurance against the extent to which the costs of bank failures are borne by individual Member States, the reform could mean lower risk premia for Ireland, and hence lower government debt interest costs. It could provide further scope to allow automatic stabilisers to operate in a downturn (by alleviating pressure to consolidate). And it could also limit the likelihood of systemic crises in future (including sovereign-bank doom loops).

The reforms are not costless. A series of large bank bailouts in future could entail requirements for additional capital to be paid into the ESM to shore up the ESM's creditworthiness (hence preserving its capacity to borrow funds and lend to crisis countries). Ireland's paid-in capital currently amounts to €1.3 billion of the €80.5 billion total reflecting its 1.59 per cent contribution key (ESM, 2012). Ireland has also committed a further €9.8 billion of the ESM's €624 billion of callable capital. Bank losses in the last crisis were exceptionally large in some cases and so the risk of these funds being required is not negligible.[19] While financial crises occur infrequently (about once every 24 years on average), the realisation of contingent liabilities tend to be highly correlated during crises (IMF, 2016). Macroeconomic downturns tend to trigger other shocks, including financial sector crises, bailouts of state-owned enterprises and subnational governments, and other contingent liabilities. A risk is that future crises require Ireland to commit some of these callable amounts, if not more. It is plausible that such requirements might also entail adverse external economic conditions for Ireland. Spillovers from deteriorating financial conditions elsewhere might be expected to reduce Irish exports, domestic demand, and possibly even to transmit to weaker financial conditions domestically. Finally, to the extent that moral hazard problems exist—as with any insurance mechanism—risks of future bailouts might be aggravated by the reforms.

Other reforms

Other reforms will see the ESM's financial assistance tools developed. These include making eligibility for the ESM's precautionary lending more transparent and predictable, thus increasing its accessibility during liquidity crises. So-called "Single-limb Collective Action Clauses" are to be introduced by the ESM by 2022. These will allow a supermajority of bondholders to agree to debt restructurings that are legally enforceable on all bondholders, making debt restructuring smoother when needed (avoiding holdouts).

In addition, there is an agreement between the ESM and the European Commission on cooperation between the two institutions. This would cover partaking in missions related to economic policy coordination and budgetary monitoring; eligibility assessments; debt sustainability assessments; financing needs; financial stability risks; policy conditionality (e.g., goals and expected impacts of reform measures in relation to the financing needs to help Member States financial situation and refinancing capacity); and compliance and post-programme monitoring.

[19] Most notably, Germany's Hypo Real Estate was provided with guarantees of €145 billion between 2008 and 2010, while Dexia in 2008 was backed by French, Belgian and Luxembourg state guarantees amounting to €135 billion (Bruegel, 2018). In terms of adjustment programmes during the financial crisis, some €480 billion of external support was required for five euro area countries during the period 2010 – 2018 (Greece, €289 billion; Ireland, €67.5 billion; Portugal €76 billion; Spain, €41 billion; and Cyprus, €7 billion), which is more than the ESM's current lending capacity.