

Bocconi

A EUROPEAN SECURITY FUND FOR UKRAINE

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Introduction

A coalition of most EU Member States plus the UK and Norway should create a European Security Fund to provide Ukraine with a reliable source of financing, large enough to substitute the US.

There exists an encouraging precedent. Back in 2010 the EU faced an existential crisis. Financial markets were in turmoil with many fearing a generalized bank run.

One of the smaller EU member countries, Greece, was at the epicenter of the crisis, but it proved impossible to use EU institutions to organize a rescue.

Only when financial market tensions became unbearable, a solution was found: euro area member countries joined forces and created a special purpose vehicle, dubbed the European Financial Stability Fund (EFSF) supported by 440 billion euro in guarantees, later increased to € 780 billion that could provide countries under financial stress with emergency long-term financing on the back of its own high rating.

Today the EU faces an even more existential crisis. A revanchist Russia is being held at bay only by the heroic defense of Ukraine.

Military and financial support coming in about equal measure from Europe and the US has enabled Ukraine to hold off Russia for over 3 years. But US support has suddenly been withdrawn.

Even if it was partially reinstated, as many hope, it clearly can no longer be relied upon. Europe must thus dramatically increase its support for Ukraine and clearly signal that this will continue as long as necessary.

EU-level initiatives face the problem that they can be paralyzed by a veto from a single member country.

So far enormous pressure has succeeded in overcoming the resistance of Viktor Orban's Hungary to various EU support packages for Ukraine. But this cumbersome process has delayed many decisions and might not work tomorrow.

Furthermore, the existing packages were considered adequate under the hypothesis that US support would continue.

Clearly further packages will now be needed, and the Orban problem will become even more difficult over time as other countries might join his Moscow friendly position.

The EFSF experience provides a useful example of how to escape the veto problem.

A coalition of the willing should create a European Security Fund (ESF) via an intergovernmental treaty.

Participants would probably encompass most EU Member States plus the UK and Norway. This fund would finance itself on the capital market to provide Ukraine with loans at favorable rates. The loans would be very long term and could be collateralized by the returns on Russian assets.

Participating countries would provide guarantees for the bonds to be issued by the EFS. The guarantees would be proportional to national GDP.

Even limiting the guarantee amount to 5 % of GDP would provide the ESF with guarantees of about 1000 billion euro given the combined GDP of the EU, the UK and Norway of about 20 000 billion euro.



The € 780 billion guarantees for the EFSF were equivalent to over 8 % of GDP then. What is proposed for the ESF would thus be smaller relative to today's GDP.

These guarantees would give the ESF a top-notch rating, like the EFSF, and allow it to finance itself at a low cost.

The guarantees would not constitute joint and several obligations. The risk for each participating country would remain limited to at most 5 % of GDP.

The initial financing requirements of the ESF would be much smaller than those of the EFSF, that had to take care right away of Greek debt amounting to 130 billion euro.

By contrast, substituting US for aid for Ukraine would require only about 50-60 billion euro annually. The ESF should thus start with a pre-agreed annual flow of loans of about this magnitude.

A large part of this funding for Ukraine would flow back to Europe through orders for European, tanks, ammunition and even planes. A significant fraction would remain available for highly efficient Ukrainian manufactures of traditional armaments but also cutting-edge drones. Many of the intermediate inputs needed in Ukraine would probably also come from Europe.

Even with a 5 % of GDP limit, the ESF would have enough fire power to support Ukraine for many years to come. This would constitute a powerful message to Russia that Europe is really serious about doing 'whatever it takes' to stop its war on Ukraine and democracy in Europe. The aim of the ESF would of course not be to prolong the fighting, but to make it more likely that Putin agrees to stop his aggression. Even when, if, the fighting stops Ukraine will need financial support, including for its reconstruction. The ESF could also finance these expenditures.

Details: Timing, Participation, the UK and Decision Making

Given the precarious situation of Ukraine time is of the essence. The EFSF was set up in a few months. Euro area finance ministers decided to set up the EFSF in May and by July it was already operational.

Bond issuance came somewhat later, when the national parliaments of enough participating countries had ratified the treaty. The ESF could thus be up and running this summer.

It would not be necessary to have all EU members on board. The fund could achieve a lending volume of over 500 billion euro already if only the four largest EU members and the Nordic countries participate.

The role of the UK is the opposite of the situation in 2010. The UK, a member of the EU then, did not want to participate in a euro area rescue operation.

Today the UK, although outside the EU is very much willing to participate in a European initiative to rescue Ukraine. Its contribution to the ESF would be about 15 %.

That of Norway could also be significant if the country were to accept a higher contribution than the one based on GDP.

The decision-making mechanisms of the EFSF could also serve as a blueprint for the ESF. The main decision-making body of the EFS should be the finance ministers of the participating countries, with defense ministers as alternative members.



Major decisions like enlarging the size of the fund or engaging in new activities would be taken by unanimity.

Like for the EFSF, decisions on ramping up support in a crisis could be taken by a super majority that was 85 % for the EFSF1 (and the ESM later).

Conclusion

The ESF should be considered an emergency measure that could morph into a more complete EU-based security and defense mechanism. But this will take time.

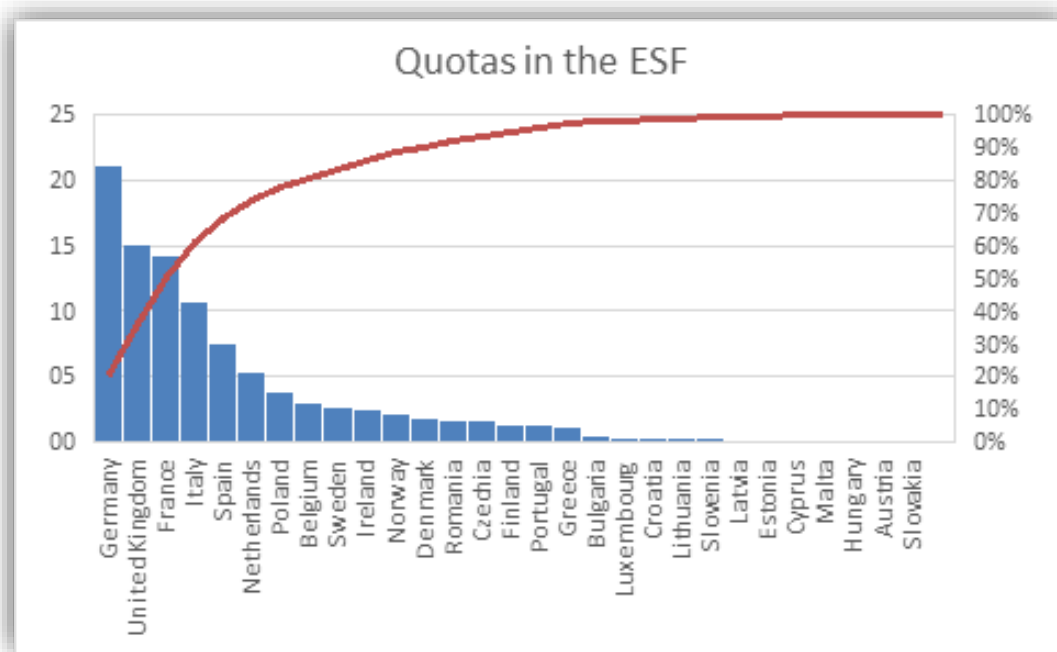
The EFSF was meant to have been temporary. It was later folded into a permanent structure the European Stability Mechanism, when it became clear that the euro area needed a permanent rescue fund.

Likewise, the ESF should also be considered as a steppingstone towards a more permanent financing mechanism for European security and defense.



Annex

Percent distribution of quotas in the ESF assuming Austria, Hungary and Slovakia do not participate (quota zero). The red line shows the cumulative share of the largest countries. The 12 largest economies, all of which are certain to support Ukraine account for 90 %.



Source: own calculations based on Eurostat 2023 GDP figures.

