

LOOKING FOR THE SILVER BULLET

A COMPREHENSIVE GUIDE TO THE DEBATE ON ESM REFORM

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SUMMARY

The debate about the future of the European Stability Mechanism (ESM) has taken a centre stage in the discussion about the future of economic and monetary union (EMU). This is partly due to the possible departure of the IMF from European programmes and to the idea to make the ESM a permanent backstop for banking union. But this is also because **changing the ESM treaty is seen by many as a quick-fix alternative to a proper overhaul of EMU architecture that would include EU Treaty change.**

Here, the cart is put often before the horse: Discussions on the precise vehicle of a reform (in this case the ESM) take priority over properly assessing the need of a tool itself. **The question how to reform the ESM is not the most fundamental one facing EMU today; but ESM reform can nevertheless contribute to making EMU more stable.**

This paper argues that **the discussion on ESM reform in fact subsumes four separate policy debates.** These debates are only loosely linked functionally, but are often being connected politically. The paper gives an overview and assessment of the most important proposals in each of these four debates:

The first debate concerns the **use of ESM funds.** The paper argues that it would be beneficial to make the ESM the permanent backstop for the Single Resolution Fund. It is also open to a possible rapid response facility to provide emergency liquidity to Member States and to the idea of a rainy-day fund inside the ESM. However, how to best design a fiscal capacity should be discussed and decided before considering the institutional location of this capacity.

The second debate is on the strengthening of market discipline through an “insolvency regime for states”, i.e. **private sector involvement** in ESM programmes. The paper dismisses the idea of automatic extensions of bond maturities at the start of an ESM programme as pro-cyclical and too risky. It is more open to bringing ESM rules closer to IMF practice, in particular by making debt sustainability a criterion of ex-ante conditionality. However, this would need to be linked to other changes to EMU architecture such as the introduction of a safe asset.

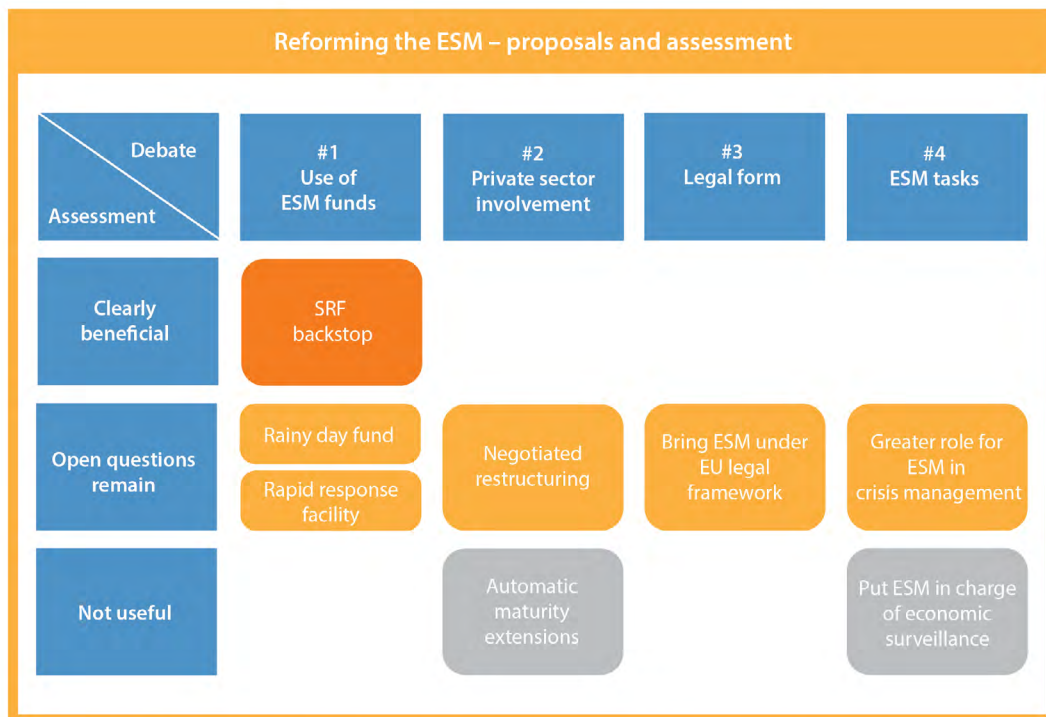
The third debate evolves around the **legal nature** of the ESM, in particular its possible integration in the EU legal framework. The paper argues that such an integration is in principle desirable, but would likely not have a strong impact in practice. Hence, it should be carefully considered whether to spend precious political capital on this matter.

The fourth debate finally touches upon the question of a **European Monetary Fund.** It focuses on if and how the ESM and its staff should be turned into an IMF-style organisation in charge of crisis management and possibly surveillance in the euro area. The paper cautions that one would need to argue carefully why the ESM would be less politicised and more objective than the Commission currently is. Turning the ESM

into an EMF would also require in essence the build-up of a new institution to fulfil these tasks. The paper is highly sceptical of transferring full surveillance functions to the ESM.

The paper concludes that answers in these four debates can and should be found on their own merits and should then be combined in an institutionally coherent way. However, **one should not see ESM reform as a silver bullet to change the architecture of EMU**. None of the solutions that are readily available in the four policy areas have the capacity to fundamentally alter the functioning of EMU. At the same time, the more far-reaching changes are conditional on progress in other areas and hence cannot be achieved through ESM reform alone. Therefore, ESM reform should be seen as what it is: A possibility to make EMU more stable by improving its crisis management toolkit. Not less - but also not more.

FIGURE 1 ► Reforming the ESM : proposals and assessment



Source: Guttenberg, Lucas (2017): Looking for the silver bullet – A comprehensive guide to the debate on ESM reform. Illustration: Cinthya Nataly Haas-Arana, Lucas Guttenberg

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1. One discussion, four debates

”REFORMING THE ESM IS NOT A SILVER BULLET.”

The possible departure of the IMF from euro area adjustment programmes and the growing consensus to use the European Stability Mechanism (ESM) as a backstop for the Single Resolution Fund (SRF) have made a possible reform of the ESM a salient topic again. Several euro area players, inter alia the Commission President¹ and the German Ministry of Finance,² have made proposals of various direction and detail. The Commission is now attempting to take the lead: it will most likely present a legislative proposal

that would move the ESM under the umbrella of Union law and would rename the institution as “European Monetary Fund” (EMF).

As for many euro area debates, the discussion on ESM reform has so far remained rather unfocused. Many actors try to bring in their political priorities and pet projects that have nothing or very little to do with the ESM *stricto sensu* or even with the euro area’s crisis management architecture in the broad sense. The ESM debate is used in these cases as a vehicle to discuss much larger issues relating to the institutional structure of EMU. These are, among others: Who is in charge of economic surveillance? What would a euro area finance minister do? How intergovernmental should the setup of EMU be? Do we need more market discipline? Do we need a fiscal capacity?

Reforming the ESM will not provide satisfactory answers to these fundamental questions. The changes that are possible through a change of the ESM treaty are simply not important enough to make a decisive difference to EMU architecture at large. It is not a silver bullet.

But reforming the ESM can be an important contribution to making EMU more stable – for example by providing a backstop to banking union or by ensuring that the crisis management framework is up to the task when it is needed.

This paper will argue that the current debate on how to reform the ESM should be seen as **four separate debates** that are loosely connected, but that should be looked at one-by-one in order to find the best way forward to reform the ESM. These four debates are the following:

- Debate #1: Should we **use ESM funds as the backstop for banking union or as a rainy day fund**, i.e. for purposes that are currently not foreseen in the ESM treaty?
- Debate #2: Should we make the use of ESM funds conditional on **private sector involvement**?
- Debate #3: Should we change **the legal framework** of the ESM?
- Debate #4: Should we change the role of the ESM as an organisation to turn it into a **European Monetary Fund**?

These four debates should be seen as modules. One can turn the ESM into a backstop for the SRF without changing anything else about the ESM – and this is true for proposals in all four debates. It is an entirely political choice to what extent these debates should be linked and when progress in one area should be contingent on progress in another. This is important to keep in mind when judging the proposals that are currently discussed.

The next part will briefly recall the setup of the ESM as it is today. The third section will then dissect the four mentioned debates and discuss the merits of the proposals on the table.

1. State of the European Union speech

2. The leaked BMF non-paper can be found at <http://www.sven-gjergold.de/wp-content/uploads/2017/10/17-10-10-Non-Paper-BMF-on-Reforming-ESM-09-10-2017.pdf>

2. The ESM today – a mechanism and an organisation

The ESM today has two dimensions that are largely disjoint from each other: the mechanism – i.e. the process under which Member States can receive financial assistance – and the organisation, i.e. ESM staff in Luxembourg. The debate on ESM reform often meanders between these two dimensions. Some proposals aim at changing the process, while others would alter the tasks of the organisation. Hence a clear understanding of who does what in the current setup is a good starting point.

2.1. The ESM as a mechanism

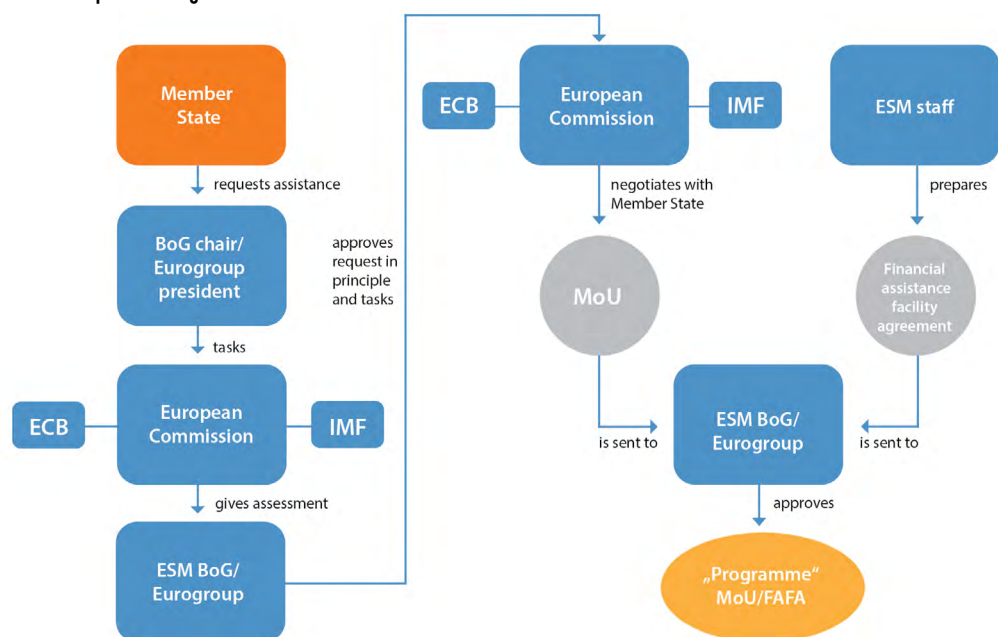
” IN ESSENCE, THE ESM IS A LARGE POT OF MONEY.”

On the one hand, there is the ESM as a *mechanism*: In essence, the ESM is a large pot of money. Member States can gain access to it through six different instruments, two of which have been used³ and four of which remain untested.⁴ When a Member State applies for one of these facilities, its request is channelled to the Commission, which from there on takes the lead on most operational fronts. It is the Commission that reviews the request in liaison with the ECB. After the request has been deemed justified in principle, it is the Commission that negotiates economic policy conditions with the Member State in liaison with the ECB and “where possible” with the IMF. It is the Commission that signs the Memorandum of Understanding (MoU) on behalf of the ESM after negotiations are concluded. And it is the Commission again, in liaison with the ECB and where possible with the IMF that monitors compliance by the Member State.

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Decisions to approve a request in principle, to conclude the MoU, and to conclude compliance reviews are taken by the ESM decision-making bodies (Board of Governors (BoG) and Board of Director (BoD)). However, these are in practice completely congruent with the Eurogroup (EG) of euro area finance ministers (BoG) or the Eurogroup Working Group (EWG) of finance ministry state secretaries (BoD). The decisions are coordinated and prepared by the EWG/EG secretariat in Brussels, an independent entity organisationally attached to the Commission and overseen by the permanent EWG president. Decisions are de facto first taken in EG/EWG meetings and then rubberstamped in formal ESM body meetings.

FIGURE 2 ▶ ESM process to grant financial assistance”



Source: Guttenberg, Lucas (2017): Looking for the silver bullet – A comprehensive guide to the debate on ESM reform. Illustration: Cinthya Nataly Haas-Arana, Lucas Guttenberg

3. Loans within a macroeconomic adjustment programme (Greece, Portugal, Ireland, Cyprus) and indirect bank recapitalisation (Spain)
4. Primary and secondary market purchase facilities, precautionary credit lines, direct bank recapitalisation

2.2. The ESM as an organisation

On the other hand, there is the ESM as an *organisation*. Its tasks derive from the provisions of the ESM treaty that prescribe a role for the ESM Managing Director (MD). The treaty foresees a clear separation: While the Commission is in the lead for all the content of the adjustment programmes, the ESM MD is tasked with the financial side of the mechanism. This means in particular proposing the choice of the lending instrument in a programme and the disbursement schedule to the BoD, managing the overall financial situation of the ESM, and overseeing the investment of the ESM's capital. Thus the ESM treaty confines ESM staff to very specific tasks related to the technicalities of lending operations. However, in practice ESM staff have started to take on more of a content-related role with the onset of the third Greek programme where they are now working on some, albeit limited, policy-related tasks.

The analytical distinction between the mechanism and the organisation is important to understand when looking at the proposals at hand. It is essential to be clear about whether proposals want to change the functioning of the mechanism or the tasks of the organisation. The one does not necessarily entail the other and vice versa. It is also important to understand that this dichotomy puts the ESM in stark contrast to the International Monetary Fund (IMF). The tasks of the Fund's area and policy departments are in the European context exercised by the Commission and to some extent by the ECB. The ESM as an organisation takes on a role equivalent to the Fund's finance department. It should also be noted that this division of labour is not only codified in the ESM treaty, but also in EU secondary law, the so-called Two Pack.⁵ Hence, changing the division of labour and the respective institutional roles would always require changing both legal texts – and, in some instances, probably even the EU Treaties.

3. Making sense of the ESM reform debate

As mentioned above, **the current debate on ESM reform spans four very distinct areas** – use of ESM funds; rules for access to ESM funds; ESM governance; other tasks for the ESM. While the first two concern the ESM as a mechanism, the third concerns both the mechanism and the organisation and the fourth is mostly about the role of the organisation. In all these areas, various proposals have been advanced to change and improve the way the ESM works today. Many of these proposals have been bundled to propose a coherent institutional solution. Indeed, such a coherent approach is necessary at the end of the debate. However, this section will take one step back and look at the most salient proposals in the field one-by-one.

3.1. Debate #1: Change the use of ESM funds

The first debate concerns the *use* of ESM funds, i.e. **the purposes for which the funds that the ESM borrows from markets can be used by beneficiaries.** Changing the use of funds means changing the mechanism, but does not necessarily entail any change to the governance of the ESM or to the tasks of ESM staff.

3.1.1. Proposal: Make the ESM the backstop for banking union

When the Single Resolution Mechanism (SRM) was established, **Member States agreed to eventually put in place a backstop for the Single Resolution Fund (SRF)**, i.e. a standing window for the SRF to borrow

5. Regulation 472/2013

” IT IS NECESSARY TO ESTABLISH A BACKSTOP AND THE ESM SEEMS TO BE THE RIGHT PLACE.”

from in case it runs out of funds.⁶ This is because the SRF is limited in size to around 55-60 billion euros,⁷ a target level that could prove too low in case of a systemic crisis in the banking sector or even in case of large short-term liquidity needs by a bank in resolution. The agreement was to have the backstop fully operational by the end of the so-called transition phase when the SRF will be fully mutualised. This transition phase ends in December 2023. In recent years, work has been carried out both at technical and political level on how to make good on this commitment. There seems to be a growing consensus among Member States that it would be easiest to use the ESM for that backstop.

How would it work? The idea is to **establish a credit line from the ESM to the SRF** on which the SRF could draw on on emergencies. The SRF has to recoup any funds that it uses in the course of bank resolutions from the banking sector; this would also apply for funds borrowed from the ESM and then used in resolution. Hence over time the probability for the ESM to incur losses is at least theoretically very limited. In terms of governance, it seems likely that approval would need to be fast and could be light-touch given that the resolution process in the SRM is already extremely complex. It involves Member State representatives at various points in the decision making. One possibility would be to pre-earmark a certain amount (e.g. the equivalent of the size of the SRF) for the credit line and only have the ESM governing bodies decide again when the borrowing needs exceed the earmarked amount.

Legal and institutional feasibility Backstopping the SRF, i.e. providing assistance to another European body, is currently not covered in the ESM's initial purpose, namely providing financial assistance to Member States. Therefore, the **ESM treaty very likely would need to be amended**. It seems unlikely that changes to the institutional structure would be required given that there is a very elaborate process on bank resolution already in place at the European level. However, one would need to ensure compliance with national constitutional requirements on ESM participation. Ideas to give ESM staff a role in the decision-making process would likely lead to duplication.

Possible alternatives Some actors⁸ have proposed to **use the EU budget as backstop**. However, it is not clear how such a solution would be superior to using the ESM. The use of the EU budget would require the agreement of non-participating Member States and would make arrangements necessary to avoid the creation of de-facto liabilities for non-participating Member States. The complications of using the European Financial Stabilisation Mechanism (EFSM) as bridge financing for Greece in summer 2015 should be a cautionary tale in this respect. In addition, there are question marks whether a backstop via the EU budget could provide a large enough coverage to sustain systemic crises. A **backstop by the ECB is not possible** due to the monetary financing prohibition, which forbids direct credit lines to public entities.

Taken together, it seems necessary to establish a backstop for the SRF; the ESM seems to be well suited to become that backstop.

3.1.2. Proposal: Build a rapid response liquidity window

The ESM so far only provides loans after a long negotiation process. In the meantime and before applying for a programme, Member States can come under heavy liquidity constraints. In the past, this situation had been alleviated by the ECB through their now-defunct Securities Markets Programme (SMP). To ensure that for a new crisis this would not fall on the ECB anymore, Enderlein et al⁹ propose the establishment of a **“rapid response facility”**.

6. See December 2013 ECOFIN/Eurogroup statement: <http://www.consilium.europa.eu/media/21899/20131218-srm-backstop-statement.pdf> and December 2015 Finance Ministers' statement <http://www.consilium.europa.eu/en/press/press-releases/2015/12/08/statement-by-28-ministers-on-banking-union-and-bridge-financing-arrangements-to-srf/?+on+Banking+Union+and+bridge+financing+arrangements+for+the+Single+Resolution+Fund>.

7. The SRF does not have a numerical target level, but has to reach at least one percent of covered deposits in participating Member States.

8. Cf. BMF non-paper

9. See Enderlein, H. et al (2016), *Repair and Prepare – Growth and the Euro after Brexit*. Bertelsmann Stiftung, Jacques Delors Institut – Berlin and Jacques Delors Institute in Paris.

” A FACILITY THAT CAN PROVIDE RAPID LIQUIDITY IS IMPORTANT IN CASE OF MARKET TURBULENCE.”

How would it work? Under its secondary market purchase facility, the ESM can already today intervene in the secondary market on short notice even when countries are still not under a programme.¹⁰ However, this requires going through a rather cumbersome decision-making process, including the negotiation of a light-touch programme. Most importantly, it has to be approved by an at least 85% majority in the Board of Governors. Ideally, **a rapid response facility would provide an instant liquidity window to calm markets** as a bridge until a programme can start and OMT would kick in as a firewall.¹¹ A fixed amount of ESM funds could be earmarked for this purpose.

It could be deployed in a rapid decision-making process (e.g. simple majority in BoG or even full discretion of ESM MD for initial purchases) with a low vote threshold to avoid drawn-out political debates and for a limited amount of time.

Legal and institutional feasibility The difference to the current secondary market purchase facility would consist in a slim decision-making process and in the absence of ex-post conditionality. The latter could prove unproblematic from a legal point of view if ex-ante conditionality were applied firmly, e.g. if full compliance with the EU economic governance framework (SGP, MIP, Semester) were a pre-condition for accessing the facility.¹² However it seems less straightforward to change ESM governance to circumvent a possible disagreement between Member States. At the end of the day, the ESM is an intergovernmental institution. Constitutional restrictions in a number of Member States, most notably Germany, make it legally very difficult to depart from the current voting procedures when providing assistance to Member States.

Possible alternatives If needed, liquidity can already be provided under the secondary market purchase facility, provided that there is sufficient support among other Member States. Alternatively, the ECB can always reinstate programmes similar to the SMP at its discretion.

A **facility that can provide rapid liquidity** seems important in case of market turbulence beyond the ECB which should not be overburdened with such tasks. It is however doubtful if a new instrument with a new governance structure could be set up easily. One way out could be to **further simplify the secondary market purchase facility**; It could be clarified that full compliance with the governance framework is sufficient to access the facility in case the ECB, as already foreseen in the guideline, confirms the existence of market turbulence. This could be backed up by a declaration of Member States that no veto would be used whenever the ECB would issue such a confirmation.

3.1.3. Proposal: Use the ESM as euro area rainy day fund

The discussion about a possible fiscal capacity for the euro area is older than the euro itself. Numerous reports, from MacDougall in the 1970s to the Five Presidents in 2015 have highlighted the **importance of a fiscal counterpart to the single monetary policy**. Proposals can be divided in three large conceptual areas: a) a discretionary euro area budget,¹³ b) a full automatic stabiliser such as a European unemployment insurance or a cyclical shock insurance¹⁴ or c) a rainy-day fund¹⁵. While putting the two former in the ESM would require considerable imaginary power and creativity, ESM MD Regling himself has proposed **to set up a rainy day fund** and to place it possibly within the ESM.¹⁶

” THE DEBATE SHOULD FOCUS FIRST ON WHAT KIND OF FISCAL INSTRUMENT WOULD BE USEFUL.”

10. Cf. Guideline on secondary market purchase facility

11. OMT is predicated on an ESM programme and hence cannot be deployed instantly when a country comes under market pressure.

12. The ECJ has made clear in its Pringle judgement that the conditions for ESM assistance need to ensure that incentives for sound policymaking are not undermined. Conditionality is one possible solution for this.

13. See e.g. Macron in his Sorbonne speech

14. See e.g. Dullien, S. (2008), *Eine Arbeitslosenversicherung für die Eurozone : ein Vorschlag zur Stabilisierung divergierender Wirtschaftsentwicklungen in der Europäischen Währungsunion*. SWP-Studie; Enderlein, H., L. Guttenberg and J. Spiess (2013), *Blueprint for a Cyclical Shock Insurance in the euro area*. Notre Europe Study.

15. See e.g. in IMF (2013), *Toward a Fiscal Union in the Euro Area*. IMF Staff Discussion Note.

16. See e.g. https://www.esm.europa.eu/sites/default/files/2017_07_13_regling_hb_de.pdf

How would it work? In cases of severe asymmetric shocks or downturns, Member States would receive budgetary transfers from a central, pre-funded pot to smoothen public expenditure and avoid pro-cyclical cuts. This would **provide an element of cross-border stabilisation** to compensate for foregoing the possibility to stabilise via national monetary policies. Thresholds for triggering pay-outs would need to be pre-defined. Disbursements would need to be linked to compliance with economic governance rules to avoid moral hazard. Placing the rainy day fund within the ESM could mean using parts of the already paid-in ESM capital as starting point for the fund to have it readily available in a short period of time. However, a scheme to regularly refill the fund would be necessary to avoid that the ESM cannot fulfil its original task, namely to provide support to countries losing market access, and to ensure that the ESM can retain its AAA rating.

Legal and institutional feasibility The ESM as an organisation is experienced in administering a large pot of money that is relatively rarely used and hence could host the financing arm of a rainy day fund; it would be relatively easy to use some of the ESM funds as starting point. It is less clear whether the intergovernmental decision-making process of the ESM as it stands today is well-suited to decide on when pay-out thresholds are actually reached.

Possible alternatives It is beyond the scope of this paper to discuss other possible fiscal capacity solutions. As to the rainy day fund, this could also be placed in another body, e.g. an EU agency as akin to the Single Resolution Board which also administers its own fund.

It is **beyond the scope of the paper to discuss the merits of a fiscal capacity in general or the right choice of the instrument**. If one wanted to settle on a rainy day fund, placing it within the ESM would seem to make sense if the purpose was to get the fund started relatively quickly as then, existing ESM funds could be tapped. If however the idea was to build the fund from scratch, it would seem that a clear separation between financial assistance for countries losing market access involving hard conditionality on the one hand and genuine fiscal stabilisation on the other hand would make sense to ensure institutional clarity. The rainy day fund as part of EMU economic policymaking could be set up as a fund under the purview of the Commission with rules decided by EU legislators and could then be funded by dedicated resources. It could even be integrated as a flexible line in the EU budget.

3.1.4. Conclusion

Given these three proposals, **it seems most promising to change the use of ESM funds to include a backstop for the Single Resolution Fund**. Such a backstop is necessary and the ESM is well-suited to be its institutional locus. It **could make sense to set up a rapid response facility** provided that a way can be found to trim down the decision-making process. The discussion whether or not to have a rainy day fund should be conducted independently of whether or not in the end it would be placed within the ESM. The **debate should focus first on which fiscal instrument seems the most useful** to ensure a better absorption of macroeconomic shocks. In a second step, it could then be decided where to place this fiscal capacity to ensure maximum effect while guaranteeing a high level of democratic control and institutional coherence and clarity.

3.2. Debate #2: The role of private sector involvement

Since the start of the adjustment programmes in the euro area, an intense debate unfolded in academic and policy circles whether ESM programmes should involve some form of **mandatory or optional private sector involvement (PSI)**, i.e. what some would call an “insolvency framework for sovereigns”. PSI is supposed to avoid that risks are transferred early in programmes from private to official creditors. It may also increase market discipline, counteracting moral hazard stemming from the possibility of a bailout, and could improve the ESM’s capacity to deal with countries that encounter a solvency crisis instead of merely liquidity shortages.¹⁷ The tricky thing here of course is that unlike private sector agents, sovereigns do not have clearly-delineated balance sheets and the differentiation between solvency and liquidity problems entails considerable judgment.

” THE ESM TREATY ONLY MAKES A VAGUE REFERENCE TO PRIVATE SECTOR INVOLVEMENT.”

Currently, **the ESM treaty makes only a vague reference to a possible PSI** under exceptional circumstances “in line with IMF practice”.¹⁸ There is no further formalisation or codification of this provision in ESM legal documentation except that the Commission, in liaison with the ECB, has to perform a debt sustainability analysis (DSA) when a Member State requests a programme. The treaty does not specify what would follow from a negative DSA outcome.¹⁹

Also the **reference to IMF practice does not provide much clarity**. For exceptionally high funding amounts in an IMF programme (“exceptional access”), a country’s debt needs to be sustainable with high probability or otherwise debt needs to be restructured. The situation is less clear for normal-access programmes. For the purpose of Fund-supported programmes, debt sustainability is determined on the basis of a heavily assumption-driven DSA. There is no formal or automatic restructuring regime linked to IMF programmes. All debt restructurings in Fund-supported programmes are negotiated.

There is a myriad of proposals of how a mechanism for PSI in the euro area linked to ESM programmes could be structured. Two main strands will be discussed here as stylised proposals: A formalised solution for negotiated restructuring and an automatic extension of maturities once a country enters an ESM programme. The two are not necessarily mutually exclusive but could be seen in tandem, where an automatic maturity extension would buy time for the negotiated restructuring.

3.2.1. Proposal: Establish a formal scheme for negotiated restructuring

The experience of the recent programmes for Greece has re-confirmed that **in some situations, economic adjustment under an ESM or IMF programme is not enough** to bring debt back to a sustainable level that would allow the country to reliably tap markets on its own and slowly grow out of its debt. In this case, **early PSI is likely the least costly solution** for official creditors to alleviate the debt burden on the country. In the case of Greece, a PSI was performed in 2012 on a voluntary basis by creditors as part of the second programme. However, there is no formalised way of repeating this exercise for future ESM programmes to avoid situations like today where Greek debt is still considered unsustainable by most observers.

The simplest version of a formalisation would be to include a rule in the ESM treaty that states that **if the DSA at the beginning of the negotiation process for a new programme shows that debt is not sustainable, debt restructuring has to be a part of the programme**. In that case, like in similar IMF programmes, the ESM programme would be negotiated while the Member State negotiates in parallel a restructuring of its debt. The introduction of so-called single limb collective action clauses (CACs) to prevent holdouts could facilitate such negotiations. In the end there would be no programme if the country did not agree with its creditors.

17. For discussions see inter alia Zettelmeyer, J. (2017), *Managing Deep Debt Crises in the Euro Area: Towards a Feasible Regime*. PIIE.

18. Recital 12: “In accordance with IMF practice, in exceptional cases an adequate and proportionate form of private sector involvement shall be considered in cases where stability support is provided accompanied by conditionality in the form of a macro-economic adjustment programme.”

19. See Art. 13 ESM treaty

This seems however an unlikely outcome as in the case of a default, resulting from a lack of a programme, creditors would likely be worse off.

The merit of this proposal all hinges on communication and market perception. If a formal rule for debt restructuring is perceived by markets as a mere specification of the rule that in practice is already followed (after all there was PSI in Greece and there will likely be more debt relief at the end of the programme in 2018), then the proposal seems like a sensible further development that creates more certainty about ESM processes. Nevertheless, one should remain aware that DSAs are not an exact science and remain very vulnerable to politicisation. Even with such a rule, it would be likely that should there be no political consensus for PSI in a certain case, there would be no PSI.

” IT SEEMS WISE TO
CHOOSE STEPS CAREFULLY.”

However, **if markets were to perceive such a formalisation as a fundamental shift in how they should assess the safety of euro area government bonds, this could lead to strong disruptions in markets.**

This is particularly true at the current juncture where monetary policy has begun its path towards normalisation. It could lead to a re-fragmentation of sovereign bond markets with higher funding costs for governments that are perceived more likely to require a programme and permanently low yields for safe haven countries. The aftermath of the 2010 Deauville declaration has shown that these shifts in perception should not be underestimated. Hence it seems wise to choose steps carefully and in particular to assess to what extent such effects could be offset by a simultaneous introduction of a real safe assets for the euro area. Such a safe asset would guarantee market functioning and foster financial stability.

3.2.2. Proposal: Establish a rule for automatic maturity extensions

Some actors are concerned that **a negotiation-based system like the one above can be used to treat a solvency crisis as a liquidity crisis** and to shy away from debt restructuring. Therefore they argue that an **automatic maturity extension** when a country enters an ESM programme would provide the necessary time to distinguish between liquidity and solvency crises. The maturity extension would prevent private bondholders from transferring their risk over to the official sector while the question of debt restructuring remains unclear.²⁰

To operationalise this idea, ESM rules would be changed so that Member States have to include in all bond contracts a provision that would automatically extend e.g. by three years, the maturity of a bond in case the country enters a macroeconomic adjustment programme. During these three years, it has to be determined whether there is a need for debt restructuring. While such a maturity extension does not change the face value of the bond, it does diminish its net present value (NPV). Hence it is a form of automatic restructuring as economic value is transferred from the creditor to the debtor.

While this proposal looks intuitively sensible on the outset, it **could prove extremely risky in practice as it could have strongly pro-cyclical effects.** Once a Member State comes under pressure from markets, the prospect of a programme would not have a calming effect. On the contrary investors fearing the NPV loss would aim at selling their bonds before the start of the programme. This would intensify market pressures and possibly lead to a self-fulfilling dynamic.

On top of that, it seems very likely that the mere prospect of a programme would lead to ineligibility of bonds of that Member State for ECB monetary policy operations, or the very least to strongly increased haircuts in the collateral framework. In a situation where a NPV loss is imminent, buying a Member State's bonds or accepting them as collateral without adequate safeguards seems hard to reconcile with the monetary financing prohibition. In turn, this could further destabilise the banking system in the respective Member State.

” IT IS DOUBTFUL WHETHER
AUTOMATIC MATURITIY
EXTENSIONS WOULD IMPROVE
FINANCIAL STABILITY.”

20. See e.g. Bundesbank (2016), *Approaches to resolving sovereign debt crises in the euro area*. Monthly Report July 2016.

Finally, during the last crisis **four out of five programme countries regained full market access without any restructuring**. Hence, automatic maturity extensions would have had in these cases more of a punitive character that would not have been economically necessary but could have had detrimental effects on financial stability.

Weighing these three arguments, **it is highly doubtful whether such an instrument would really contribute to increased financial stability**. In particular it is not clear if it would be superior to a negotiated solution if PSI was necessary.

3.3. Debate #3: Change the legal status of the ESM

On 6 December, the Commission will most likely propose to **incorporate the ESM, currently an international organisation, into the Union legal framework**. The ESM as a mechanism already today makes heavy use of EU institutions: Commission and ECB participate in programme design and review while the ECJ is the court of adjudication for any dispute under the ESM treaty. The Eurogroup is de facto the supreme decision-making body of the ESM. The Two Pack has formalised the negotiation process for ESM programmes in EU law. However, the European Parliament so far has no formal role vis-à-vis the ESM MD as the parliamentary reporting on programme negotiations is done by the Commissioner in charge. The Commission will now aim at going one step further to incorporate the body of the ESM treaty into Union law.

How would it work? Taking into account the information available so far, the Commission will likely propose a legislative act under Article 352 TFEU, which allows the Union to perform actions to attain objectives of the Treaties where the Treaties have not given the necessary powers to the Union. The act will most likely **transfer the whole content of the ESM treaty into Union law**, making the ESM as an organisation a part of the family of EU bodies. It could not become a formal EU institution as this would require a change of the EU Treaties themselves. As an EU body, the ESM would likely have a formal reporting obligation to the EP similar to e.g. the ECB and would also come under the purview of the Court of Auditors. However, the governance structure would likely stay intact as a fundamental change in this realm, e.g. a shift to majority voting in the governing bodies, would lead to constitutional problems in Member States.²¹

Legal and institutional feasibility The use of Article 352 is cumbersome as it **requires unanimity in the Council** - including those Member States who are not members of the ESM - and the approval of the European Parliament. In some Member States, parliaments have to approve the use of the article for their respective representative in the Council to vote in favour. Beyond this, the move of the ESM under the Union roof seems a rather administrative move that would have the strongest impact on the ESM as an organisation and on its employees who would become EU employees. One would also need to assess the impact on ESM bonds already issued in the ESM's capacity as an international organisation. One remaining question mark is how the ESM under the Union roof would relate to the EU budget. In addition, bringing the ESM under the Union roof would likely justify a stronger accountability of the ESM to the EP. However, this could be challenged by national parliaments, some of which now have a strong role in controlling their national representatives in ESM governing bodies. This could prove an important political obstacle.

Possible alternatives The ESM could remain an international organisation as it is now but the ESM treaty could be changed to establish formal reporting obligations of the ESM MD to the EP. One could also give the Court of Auditors a formal role under the ESM treaty.

For the purposes of institutional clarity and legal coherence, **it seems desirable to eventually integrate all bodies of law that have a direct bearing on the functioning of EMU - the ESM treaty, the so-called fiscal compact - into the framework of Union law**. However, on the one hand it is not clear what the practical use of moving the ESM under the Union roof would be at the current juncture. The practical implications as regards the roles of the Court of Auditors and the Parliament could also be achieved in the framework of the ESM treaty and would not require an Article 352 act. On the other hand, **adopting such an act will require the Commission to spend considerable amounts of political capital** as it will need to convince

21. Most importantly, the German Constitutional Court has repeatedly emphasised the importance of the German veto as a precondition for Germany's participation in the ESM.

all Member States of the usefulness of this move. The bargaining power of the Commission and also of the European Parliament in this realm seems rather weak as Member States seem content with the status quo. This would also imply that neither the Commission nor the EP are likely to substantially increase their own roles as Member States have a comfortable fall-back position in the status quo.

” **ACHIEVING UNANIMITY IN THE COUNCIL SEEMS A HIGH PRICE FOR VERY LIMITED PRACTICAL USE.**”

To sum up, this debate is entirely driven by the Commission and seems to be mostly motivated by its wish to establish the ESM within the Union's – and thus its own – realm. This is to cement the status quo in a different field, namely economic surveillance (see debate #4 below). The calculation seems to be that once the ESM is an EU body, it becomes less likely that it will be seen as an attractive alternative to the Commission for rule enforcement. However, **achieving unanimity in the Council under considerable costs seems a very high price for such an outcome that will likely have very limited practical use.**

3.4. Debate #4: Change the role of the ESM into an IMF-type organisation

Over the course of the last two years during the review process of the Greek programme, the **role of the IMF in the euro area crisis architecture has become less and less certain**. Differences between IMF and Commission/ECB/ESM staff became apparent on methodological questions as well as on political and economic judgment. In addition, the IMF's Independent Evaluation Office issued a critical report on the Fund's role in the European programmes, calling into question whether the Fund should participate in the same way in the future.²² At the same time, **the ECB's leadership had stated consistently in the past that the ECB “will not be in the troika forever”**.²³ Finally, the **Commission has come under increased pressure for its role in economic surveillance**. In particular its implementation of the Stability and Growth Pact (SGP) has been criticised as too political in Germany.

Taken together, some actors seem to think that this is the **right moment to discuss turning the ESM into a full “European Monetary Fund” (EMF)**.²⁴ Some, including most prominently former German Finance Minister Schäuble, had called for such an organisation that would be able to administer European adjustment programmes autonomously already at the start of the programmes in 2010. Now this debate has resurfaced and concentrates on two aspects: First, should the ESM as an organisation play a bigger role in crisis management? Second, should the ESM take on a stronger role in economic surveillance, i.e. in crisis prevention? In short: **Should the ESM become a European incarnation of the IMF?**

Behind this debate, there is a bigger question on the future institutional architecture of EMU: **Should EMU be chiefly governed using the traditional community method with the Commission at its centre . Or should it move more firmly in the intergovernmental domain with a new institution at its heart?** The debate about the EMF epitomises this larger choice. But before diving into this debate, two clarifications about the IMF seem necessary to inform the debate about a possible EMF as they are often misunderstood in the European context:

- First, **the IMF is not an apolitical organisation**. There is a clear separation between IMF staff and management on the one hand and the Fund's Executive Board on the other. Nevertheless, the Board has to approve all IMF lending programmes. To ensure passage, Fund staff and management extensively reach out to Executive Directors – and in particular those commanding a lot of votes in the Board²⁵ – to prepare the ground for an affirmative decision of the Board. The more politically sensitive a programme is the more political decision-making becomes.
- Second, **IMF surveillance (i.e. recommendations given to countries not under a programme in the so-called Article IV reports) is materially different from economic surveillance in the EU**.

22. Independent Evaluation Office (2016), *The IMF and the Crises in Greece, Ireland, and Portugal*. IEO report.

23. See e.g. <http://www.europarl.europa.eu/news/en/press-room/20150921IPR94090/we-will-not-hesitate-to-act-if-inflation-outlook-weakens-draghi-tells-meps>

24. It should be noted that the ECB has argued that European Monetary Fund would be a misnomer in a monetary union, as monetary policy is conducted by the ECB.

25. The 24 Executive Directors command the votes of all countries they represent. Votes are distributed according to a complex formula that roughly means that larger economies have more votes than smaller ones.

EU economic surveillance aims at constraining domestic policy choices in particular through the SGP, the Macroeconomic Imbalance Procedure (MIP). It has at the end of the day a *coercive* character. Fund surveillance is purely *advisory*. It does not seek to impose policies; it recommends them in the spirit of an honest outside advisor whose traction comes from publishing its reports. This is an important difference: The Commission always needs to factor in that it has to escalate procedures if its recommendations are not respected and has to choose its battles accordingly. The Fund does not have to make such a calculation. This also means that countries can be a lot more open to Fund recommendations.

Having these two clarifications in mind, one can discuss the two main strands of possible changes to the role of the ESM as an organisation:

3.4.1. Proposal: Give the ESM a bigger role in crisis management

Today, the ESM treaty limits the role of ESM staff in programme design, negotiation and review to the choice of the lending instrument and the preparation of the paperwork for the financial aspects. However, in practice the ESM has started to take on some limited tasks in the current Greek programme and ESM staff have been part of all review missions. This also means that the ESM has now started to build some in-house expertise for more policy-related questions. In a situation where the ECB and/or the IMF were to leave the programme work, the question is whether **ESM staff would assume the roles these two institutions have played so far or even could take over some of the tasks currently assumed by the Commission**. In this context, it is important to understand that there is at the moment no clear-cut division of labour between the institutions. Commission and IMF both cover all relevant policy areas with own staff. The ECB is more focused on financial sector matters, but still has a relatively broad approach. Hence a retreat of one or two institutions might not necessarily mean that policy areas would be left uncovered by the remaining institution(s).

If ECB and IMF were to leave the programme work, one could imagine **the role of the ESM as a “second pair of eyes” in addition to Commission staff or alternatively a clear division of labour between the two institutions in terms of policy areas**. It could either mean that the Commission would negotiate and review programmes in liaison with the ESM MD or could even specify that the Commission and ESM MD are jointly negotiating and signing the Memoranda of Understanding.

One could also imagine to go one step further and to **make the ESM fully responsible** for all programme work. This would imply an even greater build-up of expertise.

The first scenario is relatively straightforward to implement from a legal perspective by changing the ESM treaty and the Two Pack regulation. However, it **leads to some institutional convulsion**: The ESM governing bodies would mandate the Commission on behalf the ESM and would at the same time involve their own ESM technical staff. This would probably also mean that the ESM structure itself would need to be changed to establish a more political top layer of the institution. This would create an ESM counterpart that has the necessary standing to negotiate with Commissioners and if need be with the Commission President at par. It would be odd if the Eurogroup President as BoG chair herself took on this role, as the Eurogroup would at the same time be the institution mandating both the ESM and the Commission.

The second scenario of **a full ESM staff takeover of programme work would be more difficult** to carry out. Institutionally, it would simplify things: The ESM Board of Governors would just mandate its own staff to negotiate and review the programmes. It would mean to have the body carrying the political responsibility, i.e. the ESM BoG, also in charge of the operational implementation of its own decisions via the ESM staff. Today, Commission, ECB and IMF shoulder considerable political blame in programme countries without being fully able to call the shots. However, on the legal side it is not clear if the Commission, for which the Treaties foresee a central role in economic policymaking, could just be cut out when it comes to crisis management. And even if the Commission were to be excluded from programme work, it would still need to assess MoU compliance with EU law, e.g. in the area of competition policy. Hence it would need to remain involved somehow to avoid major hiccups. A complete takeover by ESM staff would also mean to separate the everyday macroeconomic surveillance by the Commission from the crisis management function. Therefore such a step would only make sense if also the surveillance was transferred.

In addition, **both approaches share obvious shortcomings**. The **ESM would need to build up considerable expertise and staff**, effectively duplicating the Commission. It would be completely unclear what these staff members would be doing in times without a programme. In addition, the crisis has shown that in the event of a systemic crisis often more than one country will be in need. Therefore the ESM would need to build up staff not only for one but for several simultaneous programmes.

”IT IS NOT CLEAR WHY THE ESM WOULD BE ANY LESS POLITICISED THAN THE COMMISSION.”

More importantly, it is **not clear why the ESM as an organisation would be any less politicised than the Commission in its programme work**. The ESM is controlled directly by finance ministers and is by no means independent. This is a feature, not a bug. The ESM BoG decides on the use of taxpayer money, and adjustment programmes are not an exact science – they require political judgment and decisions, e.g. on the size of the available envelope. As mentioned, the experience of the IMF shows that even at the Fund, political judgment plays a very important role when programmes become politically sensitive. Therefore, it would be very likely that the ESM as an

organisation would encounter the exact same political pressures as the Commission. Indeed, one could argue that the institutional provision for the Commission’s independence are considerably stronger than that of the ESM as it stands today.

3.4.2. Proposal: Put the ESM in charge of economic surveillance

The leaked non-paper by the German finance ministry of October 2017 went one step further and suggested **to put the ESM gradually fully in charge of economic surveillance in the euro area**. This idea has gained support in particular in Germany following the perception that the Commission was not properly implementing economic governance rules.

The paper proposed that eventually **the surveillance function of the Commission would be transferred to the ESM**. This would inter alia mean that the ESM would propose the opening and closing of Excessive Deficit Procedures and Excessive Imbalances Procedures to the Council. ESM staff would need to be expanded considerably to take over from DG ECFIN country desks and would need to produce its own forecasts for each Member State as forecasts are the basis for most surveillance work.

Such a shift would not be possible without an overhaul of the EU treaties. Articles 121 and 126 TFEU clearly assign the lead on economic surveillance to the Commission and the Council. These provisions would also likely stand against a light version where the ESM would produce reports akin to the IMF’s Article IV reports. This would amount effectively to a duplication of tasks that have already been assigned to the Commission. In addition, there are clear institutional obstacles: Who is “the ESM” in this scenario? Would it mean that the BoG – i.e. the finance ministers – would propose the opening of an EDP to the Council, i.e. essentially to the same group of decision-makers? This would render the current system of having two institutions involved ad absurdum. Instead one would need to fundamentally alter the functioning of the ESM to turn it into an institution with its own politically responsible leadership that could work independently of finance ministers. This leadership would need its own source of democratic legitimacy.

This proposal would require a fundamental overhaul of the ESM and of its decision-making structure. It would mean hiring a completely new set of experts and it would necessitate the establishment of a proper political leadership. Essentially, it would mean creating a new institution. At the same time, this new institution would likely come under the exact same political pressure as the Commission: The idea of an ECB-type institution for fiscal surveillance completely misses the political nature of fiscal policy. Implementing the rules of EMU economic governance means at times overruling national finance ministers and national parliaments. This requires both strong formal legitimacy and political capital. One would need to show why any new body would be stronger in this respect than the Commission with its direct legitimacy from the EP and its considerable independence provisions vis-à-vis Member State governments. In addition, one would in particular need to show why an organisation like the ESM, which is run directly by national governments, would be best placed for such a role.

In sum, it **does not seem to be a convincing idea to put the ESM in charge of economic surveillance**.

CONCLUSION

The discussion on the reform of the ESM is multi-faceted: It concerns four materially different policy areas that do not have immediate links. The fact that actors make these links to further their political agenda or to shore up their own competences is neither surprising nor reproachable; but observers should remain acutely aware of the difference between functional and political links.

Many of the proposals currently on the table have interesting starting points but are often not completely thought through. In particular, it is not clear if the ESM is the right vehicle for e.g. creating a fiscal capacity or increasing market discipline. The fact that the ESM treaty is seemingly easier to overhaul than the EU treaties themselves creates a temptation to see ESM reform as a silver bullet. Second-best solutions via the ESM could indeed in some instances mean considerable progress. However, one should also be aware of the limitations of this approach and of the trade-off of discussing EMU reform solely in the realm of the ESM instead of having a broader debate on the institutional structure of EMU at large.

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