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A missed opportunity – 5 reasons why ESM reform will fail to deliver

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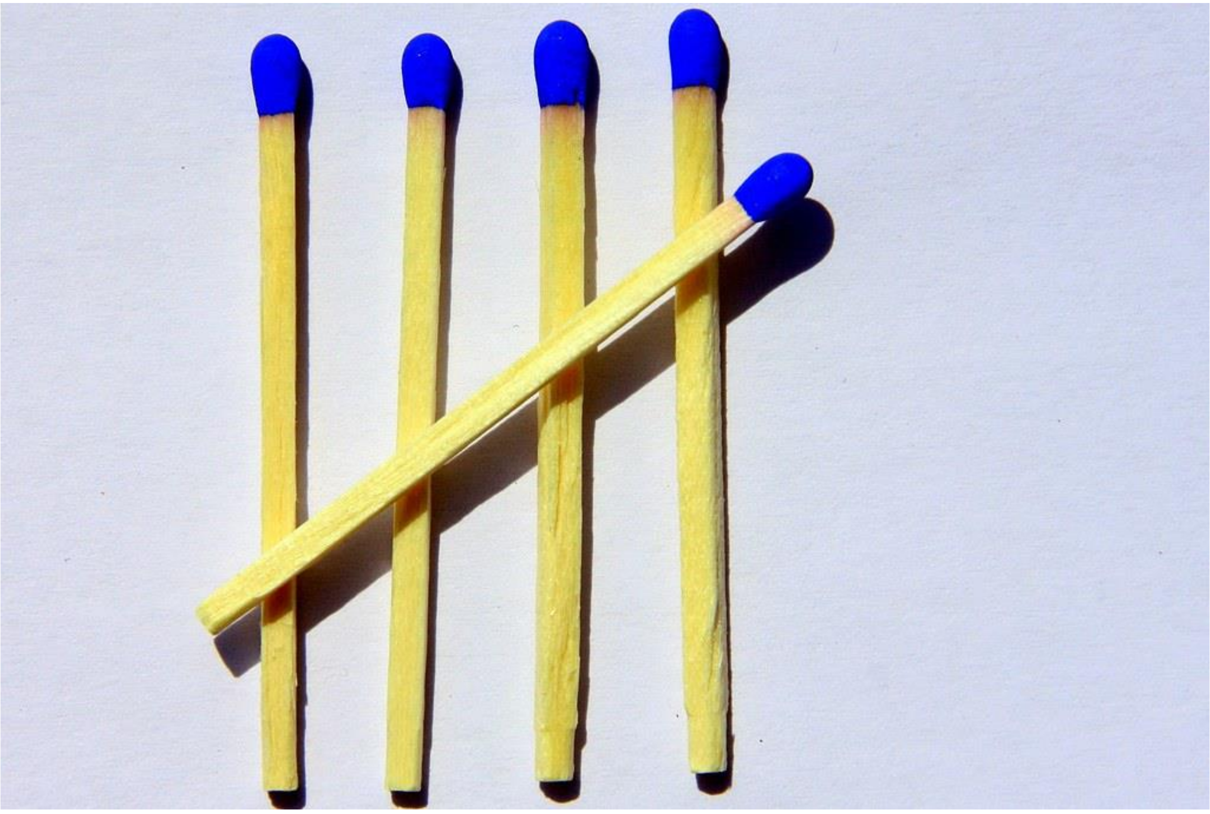

In this policy brief, Lucas Guttenberg looks at the planned reform of the European Stability Mechanism (ESM). He argues that while the reform is necessary to finally bring home the backstop for banking union, it clearly falls short of its initial ambition to also substantially improve the Eurozone's crisis management framework.

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In December 2018, the Euro Summit agreed a term sheet on how to reform the European Stability Mechanism (ESM). In June this year, the summit is due to endorse concrete changes to the ESM treaty. The debate on reforming the ESM was triggered for a rather narrow reason: the necessity to re-open the ESM treaty to include a backstop function for the Single Resolution Fund to finally make headway towards completing banking union.

But once the debate had started, ambition became plentiful in particular in some member states to attach to the backstop a comprehensive reform of the ESM: a new "European Monetary Fund" would finally make Europe independent of US influence in the International Monetary Fund (IMF). By addressing the main remaining gaps, the reform would turn the arrangements quickly built during the crisis into a more stable and sustainable crisis-management architecture.

Before diving into the matter, one point of clarification is necessary: We often have a potential crisis in Italy in mind when we discuss Eurozone crisis management and possible reforms thereof. But looking at the sheer size of the Italian economy and of its outstanding debt, it seems unlikely that the ESM – neither in its current nor after any of the possible reforms – with its large, yet limited, volume would be the weapon of choice in such a crisis. Arguably, in such a situation the ECB would be the only institution with the necessary resources.

So when we talk about ESM reform, Italy is not the scenario we should have in mind. Instead, there are two central scenarios for which the ESM was built and which should be the benchmark for judging any potential reform paths to ESM: First, a small- or medium-sized member state loses market access on its own. Second, one or several of these member states are an innocent bystander affected by contagion coming from another member state.

As argued before, ESM reform is not a silver bullet that can solve all the problems of the Eurozone. Yet the backstop has opened a window of opportunity to substantially improve the Eurozone's capacity to resolve crises in the future. As I will argue in this policy brief, this opportunity is very likely to be missed – indeed the planned reform might make matters worse in some areas. There are five main reasons for this:

1. As unanimity remains the main decision-making mode, the reform does not change the fact that crisis-management remains highly dependent on the political mood in member state capitals.
2. The reform does not remedy the problem that contagion coming from large member states is hard to contain under the current decision-making procedures.
3. The reform effectively removes precautionary lending from the ESM toolbox.
4. The reform does not clarify how the Eurozone plans to deal with unsustainable public debt in the future.
5. The reform charges ESM staff with new tasks but does not change its internal structure and accountability channels accordingly.

1 Reason One: Unanimity remains untouched

During the Eurozone crisis, it was not the sophistication of its institutional setup that kept the Eurozone together. Rather, two factors mattered: First, the ECB proved to be inventive and acted forcefully. But second, and even more important, in the end all member states had the political will to keep the euro alive. Governments and political parties in a large number of member states on both sides of the north-south divide paid a substantial political price for this. But it worked.

The problem now is: The whole architecture still depends on this political will remaining in place during the next crisis. But we have no guarantee that this will be the case. All major ESM decisions still require unanimity – in particular any decision to grant financial assistance. A number of countries also need the approval of their national parliaments before they can vote in favour. And while there is an emergency procedure reducing the majority threshold to 85% if the European Commission and the ECB attest an immediate danger, it is unclear whether politically this can ever be used except in cases of openly obstructionist governments. In any case, even at 85%, the three largest member states still have a veto (see also reason two below).

This is in stark contrast with the IMF, where no Executive Board member from any EU member state ever asks a national parliament for its assent before voting in favour of a programme – and where no EU member state has a veto despite all of them incurring a financial risk every time the Fund lends money.

The reliance on unanimity leaves Eurozone stability vulnerable to the political mood in each and every member state – and markets know this, which increases the probability of a multiple-equilibria crisis. The political environment at the beginning of the 2010s was materially different in terms of the strength of Eurosceptic parties compared to the set of parties and governments with which we will enter the 2020s – and even in mainstream parties in a lot of northern member states there is widespread Eurozone fatigue. Therefore, it is far from guaranteed that in each and every situation all member states will always be on board.

The planned ESM reform could have changed this by introducing qualified majority voting for programme decisions. Clearly, this was politically not on the cards and at least in Germany ending the veto could lead to constitutional problems. Yet, whatever the reason behind it, the lack of governance reform means that the ESM remains an institution that cannot move an inch without unanimity – and that could be a major problem in future.

2 Reason Two: Contagion from large countries remains hard to contain

Sticking to unanimity is usually discussed in the context of possible veto by reluctant "creditor" countries. But there is another context in which the veto takes on a wholly different meaning: Should a large member state decide to play uncooperatively e.g. by openly defying the fiscal rules, this could have contagion effects on other member states. Shoring up the rest of the Eurozone – and in particular small and vulnerable member states – against this contagion via ESM instruments such as precautionary credit lines could be necessary.

However, the ESM could not be used to protect other countries against contagion from a large member state's behaviour without that member state's consent as in the case of France, Germany or Italy the emergency procedure outlined above does not apply due to their veto power. It seems very unlikely that in case of a conflict between that country and "Brussels", the government of the country in question would agree to ESM action to the benefit of other member states.

This is even true in the less extreme scenario when a large member state comes under pressure from markets without a political conflict with the rest of the Eurozone but simply because of policy mistakes: In this case, shoring up other member states would mean acknowledging that there is a problem that requires such drastic action. This is the last thing a government would be willing to publicly accept.

Again, alleviating this problem would have meant amending ESM governance. At the very minimum, it would have required lowering the majority requirements under the emergency procedure. But the planned ESM reform does nothing of that sort and leaves it vulnerable to paralysis in one of the two central scenarios for which the ESM may next be required.

3 Reason Three: Precautionary lending gets gutted

The previous crisis has demonstrated the often heavy political price that governments have to pay when they enter a full-blown ESM programme. Naturally, this experience has further increased the incentive for governments to wait until the last minute to request financial assistance – an incentive structure that could make a programme unnecessarily costly for all sides. This is why when the ESM was created in 2012, the treaty already foresaw the possibility of extending precautionary credit lines to member states as long as they fulfilled certain ex-ante eligibility criteria.

Currently, countries can request access to precautionary lending under the Precautionary Conditioned Credit Line as long as they fulfil their obligations under EU economic surveillance. This means that, even if a country is under an Excessive Deficit Procedure (EDP) or an Excessive Imbalances Procedure (EIP), it may still ask for a precautionary credit line as long as it complies with the recommendations addressed to it under those procedures. In addition, there is the Enhanced Conditions Credit Line (ECCL) for countries that do not fulfil the PCCL criteria. Under the ECCL, countries need to take active policy action, which brings this instrument very close to traditional adjustment programmes, just without actual money flowing.

In practice, this possibility has not been used so far while IMF experience with precautionary credit lines has been mixed. Yet there are good arguments why having an intermediate facility short of a full programme could be beneficial for countries that find themselves under market pressure due to contagion from others. This is why France and Germany called in their Meseberg roadmap for making "existing precautionary instruments more effective". And indeed, clarifying the rules for the precautionary credit lines could be useful to make their use more practical – in particular by making it clear that as long as a country plays by the Eurozone rules, it can access the PCCL without any further strings attached.

The planned reform does nothing of that sort. For the PCCL, it symbolically abolishes the need for a Memorandum of Understanding (MoU) between the ESM and the member state and replaces it with a "Letter of Intent" (LoI) by the member state. Interestingly, this is exactly the document the IMF already uses for all its programmes – and of course, LoIs in the IMF context are no less an outcome of negotiations than MoUs in the ESM context.

The counterpart to this symbolic gesture is a significant hardening of the criteria for accessing the PCCL. Thus, the reform effectively kills the instrument. Now countries under Excessive Deficit Procedure will be excluded upfront. As a reminder, during the financial crisis all Eurozone countries except Luxembourg and Estonia were in the EDP – this as simply a consequence of the fact that EDP triggers are nominal and tend to flash during downturns. So, in a comparable situation, precautionary lending would now be out of reach for practically all Eurozone countries.

But there is more: Countries will also need to meet quantitative benchmarks in the two years before requesting a precautionary credit line. This includes the debt benchmark, which requires a constant reduction of debt-to-GDP for countries whose ratio exceeds 60%. Even in only a mild downturn trying to further reduce the debt ratio does not make much sense from a macroeconomic perspective. That is why the fiscal rules give the Commission ample room to disregard breaches of the debt benchmark if that seems reasonable. Yet, for the purpose of precautionary lending, the December summit decision foresees no wiggle room whatsoever. This will further drastically reduce country eligibility as soon as the macroeconomic outlook becomes a shade cloudier.

Finally, member states will not only have to meet these criteria when they apply for a precautionary credit line – they will have to keep meeting these criteria as long as they want to have access. This means that in a downturn in practice a country can choose between a fiscal response or the precautionary credit line; it will hardly be able to have both at the same time given the very restrictive nature of the eligibility criteria on the fiscal side.

Precautionary lending is supposed to be an instrument that prevents vulnerable yet fundamentally still robust economies from contracting serious diseases. The reform will likely shut the door of the doctor’s practice on all those with as little as a runny nose, leaving the emergency room – a full ESM programme with all its stigma and political costs for the Eurozone at large – as the most viable option when it’s already too late.

But it might not be too late for last-minute corrections prior to the June summit: It could for example still be clarified that the ECCL will be, without further strings attached, open to countries that comply with the economic governance rules but do not meet the PCCL criteria. These countries would then not need their policy and would not need to make further policy commitments in the Memorandum of Understanding as long as they comply with their EDP/MIP recommendations. However, this seems politically very unlikely at this stage.

4 Reason Four: Treatment of unsustainable debt remains unclear

With hindsight, a key lesson of the three successive Greek programmes is that the country’s debt is unsustainable – and in all probability has been unsustainable for a long time without any adequate instruments in the ESM toolbox to deal with it. In an ad-hoc procedure subject to much litigation, Greece and its creditors agreed on a voluntary debt exchange in 2012. Last summer, Greece and the Eurogroup agreed additional debt measures.

While these measures somewhat served their purpose, they have delivered very limited predictability to markets about what would happen in a similar situation in future. The ESM treaty itself also provides little orientation. It prescribes a debt sustainability analysis (DSA) as part of preparing every programme, but does not specify what happens if the DSA is negative. It also contains a recital that refers to “IMF practice” for private sector involvement in “exceptional cases” – but does not specify how this is connected to the DSA. This kind of uncertainty is certainly problematic if one desires greater market discipline – but it is also suboptimal if one chiefly wants to avoid market panic due to uncertainty.

The ESM reform could have clarified the procedure. At the very minimum, it should be made clear that where debt is clearly unsustainable, bringing it back to sustainable levels should be a necessary part of the programme measures. But the planned reform does not contain such clarification. Instead, the term sheet “reaffirm[s] the principle that financial assistance should only be granted to countries whose debt is sustainable and whose repayment capacity is confirmed.” Interestingly, this principle was not contained in the ESM treaty before. In addition, all countries will now have to include so-called single-limb collective action clauses in their bonds to make restructuring easier and the ESM can “facilitate the dialogue between its Members and private investors.”

In sum, the term sheet drops a number of hints that indeed restructuring should happen if debt is clearly unsustainable but then stops short of providing predictability as to what will actually happen next time the situation arises.

5 Reason Five: ESM staff gets real tasks – but not the governance to fulfil them

A major treaty change this reform will introduce is an increased role for the ESM as an organization (read here about the distinction between the ESM as a mechanism and as an organization). At the moment, ESM staff have only a very marginal formal role in the design and monitoring of programmes – the bulk of the responsibility lies with the European Commission and to a lesser extent with the ECB and the IMF. Member states have agreed in the term sheet to change this in line with a joint position by the ESM and the European Commission.

Crucially, ESM staff will participate in the DSA. In case of conflict with the Commission, ESM staff will be tasked to determine the “repayment capacity” of a Member State when entering a programme. They will also contribute to the formulation of programme conditionality. This is manifestly different from what ESM staff have formally done so far. Crucially, the new tasks will require the ESM to have an institutional view on very sensitive issues such as determining the debt sustainability of a member state requiring a bail-out. The question then is who decides on this institutional view.

Unlike the Commission or the ECB, the ESM has no decision-making bodies of its own that would enjoy some degree of independence: Board of Governors and Board of Directors are fully in the hand of member states, even more so because unanimity reigns. So giving a task "to the ESM" either means giving it directly to member states or giving it to the managing director (MD). And, arguably, the difference between the two is marginal as the MD directly reports to the member states. The MD has no independent source of legitimacy unlike the Commission that derives half of its own legitimacy from the EP. The MD has no safeguards for her independence unlike the ECB which enjoys the full force of the independence provisions of the EU treaties. Indeed, the Board of Governors can sack the MD by qualified majority at any point in time. Finally, the MD has no own formal channel of parliamentary accountability where she could get backing for her actions.

None of this was a major issue as long as the ESM was a mere financing vehicle. The moment it has to take politically sensitive decisions, this seems no longer tenable: The judgments the Commission so far has taken in cooperation with the IMF and the ECB and will share in the future with the ESM are necessarily uncomfortable for some member states – that is why the programme work was delegated to the institutions formerly known as the Troika in the first place.

For the ESM to be able to take such decisions without full-blown politicization but with some degree of independence would require its revamp : At a minimum, there should be some organ for collective decision-making at the helm enjoying a degree of independence from member states akin to the ECB's executive board. It should also be able to rely on a parliamentary accountability channel with the European Parliament. Otherwise the institution risks being crushed between member state's interests to the extent of potential paralysis. Just imagine state secretaries in the Board of Directors having to agree unanimously on DSA methodology!

So far, however, the term sheet foresees no change to the governance of the ESM whatsoever: a huge gap that would need to, but will likely not, be filled.

6 Conclusion

ESM reform was never supposed to be a silver bullet – but the backstop discussion had opened a window of opportunity to make the Eurozone's crisis management framework more stable and better equipped to deal with crises in the future. However, this chance was missed. The reform as it stands today will do very little on that front – and in particular when it comes to precautionary lending, it will make matters worse.

Negotiations are still ongoing for the summit decision in June. Precisely in the area where the reform could do damage, on precautionary lending, it would be good if negotiators could have another look at the provisions and make improvements. Yet given that the term sheet is already extremely detailed, scope for this is limited.

ESM reform will bring banking union closer to completion by adding the backstop. This is why despite all the criticism of the reform, it is important that it passes. But beyond this initial rationale for opening the ESM treaty, the opportunity for further strengthening ESM and EMU more broadly was missed.

Member states should now do three things: At the very least, they should make sure the reform passes and muster the political courage to ensure smooth ratification. Second, they should make improvements wherever possible in the areas outlined above. And third, they should not give the impression that this reform is the big leap forward that would allow for taking EMU reform off the political agenda in the coming years.

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Bild: Martin Fisch: Give me five! https://www.flickr.com/photos/marfis75/5780056202/in/photolist-f3PrZi-ncrvi5-oDj3HU-nvWogX-nZrHQ1-9NLikq-UZkMwt-au5ABp-2ewwTyz-26gSaMA-fSDiY5-ncEKtG-Wm3V94-eD4byh-au8g1u-4qFXAV-pw3ksu-aaqZ2d-8jCqN6-BQz4f-dBsYqs-JaVds-pwPdk-5EruxF-hENxDC-FzTXV2-n6HZLB-263V3yf-2fnrmDz-au8g55-au5Axe-UUMugA-28qUiGF-UEythv-23QGH9r-iH2S7d-2d3RSwL-5baKuB-VMM4RJ-oU3sZB-drxZV4-5baKnR-8uS8Bd-YmhRUQ-27uobd5-2dPT3Wt-UVxaF9-273VNdm-JGK6MF-5bhqoE

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