

Policy Brief

Time to come home

If the ESM is to stay relevant, it should be reinvented inside the EU

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12 November 2020

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When restarting work on reforming the European Stability Mechanism (ESM), the Eurogroup should heed the lessons of the pandemic: The ESM has become politically unviable while there is apparently a lot more flexibility within the EU treaties than previously thought. Therefore, this policy brief argues that the old reform plans should be put to one side and the ESM should be reinvented inside the EU legal order if it is to remain relevant. Such a reinvention would create a coherent crisis management framework that would be politically sustainable in the long run.

By the end of November, the Eurogroup hopes to have finalised the first major overhaul of the European Stability Mechanism (ESM) via a reform of its treaty. ESM reform was almost done and dusted by the start of 2020; its adoption was only blocked by Italy for domestic reasons. When the pandemic hit, it was put on the backburner. Now, the Eurogroup wants to put it back on the agenda and finish it off.

The reform was a bad piece of policy to begin with. Only the fact that it would have turned the ESM into a safety net for the EU's bank resolution fund made it worthwhile. Beyond that, there seemed to be very little scope for any move to materially improve how the ESM functions at the time. **But times have changed.**

The last eight months of European efforts to combat the economic fallout of the pandemic have shown that **the ESM as it exists today has become politically unviable**. Even though it is supposed to be Europe's key crisis management institution, it has played no substantial role in combatting that fallout. The loans the ESM made available are seen as politically toxic and have not been drawn down by any member states. The planned reform will not change any of this. Instead, Europe opted for developing a novel and innovative [recovery fund](#), a genuine EU solution, to do the heavy lifting. This illustrates that where there is political will, there is a lot more that can be done within the legal framework of the EU than we thought.

Against this backdrop, this policy brief suggests using the opportunity of the upcoming debate on ESM reform to think bigger: **Drawing on the lessons of recent months, the ESM should not be reformed, but should be reinvented inside the EU legal framework.** This would finally create a coherent crisis

management framework that is politically and economically viable in the long run. The ESM had a good eight years. But it's time to come home now.

1. What ESM reform was originally about

In 2013, Eurozone finance ministers agreed that the ESM should become the “backstop” to the Eurozone’s Single Resolution Fund (SRF). Should the SRF ever run out of funds, an event most likely in a systemic crisis, it would be able to borrow from the ESM. When it became clear that such a move would require a change to the ESM treaty, this triggered a debate on other elements of it. Some countries led by Germany advocated a stronger role for ESM staff in the negotiation and oversight of ESM programmes in crisis countries because they mistrusted the European Commission. In reality, this was not only an attempt to oust the Commission from programme oversight, but to establish the ESM as the central institution of European economic governance and, in the medium term, also give it oversight over the fiscal rules. Others, such as France, saw an opening to make the ESM’s precautionary instruments more accessible.

The outcome of the years-long negotiation that emerged in December 2019 was sobering: Finance ministers made good on the backstop promise, albeit by attaching very tight conditions for the use of the backstop. Symbolically, ESM staff would get a stronger role in managing the programmes. But in practice, it would likely mostly blur lines of responsibility between the Commission and the ESM and lead to more coordination efforts instead of more clarity. Finally, the compromise would make it harder rather than easier to access precautionary lending by introducing a set of tight numerical access criteria.

The reform then ground to a halt in early 2020 because Italy opposed none of these three central tenets but a separate detail of the reform: The obligation to introduce so-called single limb collective action clauses that would make it easier procedurally to restructure a country’s debt stock. But Italy had agreed to this element previously and hence it was seen as a matter of time before the whole package was adopted. Then, the pandemic struck and the reform was put on hold.

2. Why the pandemic should make us think bigger

The ESM reform was devised in a pre-pandemic world that assumed that Eurozone governance, and indeed EU economic governance, would be an intergovernmental affair for decades to come. It breathed mistrust vis-à-vis other member states and the EU institutions. In the first weeks of the pandemic, this spirit was alive and well when a new pandemic-specific credit line from the ESM was considered the most important element of Europe’s response by a number of member states including Germany and the Netherlands. This credit line stretched the limits of what was possible under the current ESM treaty and would most likely have been impossible had the reform already been enacted. Still, no country has asked for access to date.

Instead, the following weeks opened up a completely different and ultimately more successful path. First, the ECB as early as March severed the link between its policies and ESM programmes. In its Pandemic Emergency Purchase Programme, the ECB can buy selectively sovereign bonds from member states even when they are not in a programme.

Then, as the crisis deepened, **member states agreed on new tools, the Recovery Instrument and the SURE programme, that embody the opposite approach to what the ESM stands for.** These instruments are based on trust, not mistrust. Their working assumption is that member states will not squander the additional fiscal space they provide. Moreover, member states have entrusted the European Commission, not the ESM, with borrowing in the markets on behalf of the EU and overseeing the spending.

The result is striking: Member states have shied away from taking the ESM’s pandemic support loans even though they have very few strings attached. But they have been more than willing to take out SURE loans and will happily access the Recovery Instrument: They will all use its grant element and for the moment seem to keep open the option to access the loan element as insurance against future adverse developments in markets.

The Eurogroup should take **three lessons** from these recent developments:

- **First, the ESM has become politically unviable.** ESM programmes, no matter what their conditions, have become politically so costly that they will only be resorted to in very dire circumstances, i.e. when it is too late. That is to some extent unfair to the ESM as an organisation. The design of earlier programmes was in the hands of the Commission, the ECB and the IMF. ESM staff hardly played a role. But politics is rarely fair.
- **Second, EU support in crisis times carries no stigma as such.** The extraordinary take-up of SURE loans is a clear indicator here. That means that crisis-management instruments can be designed in a way that enables timely intervention.
- **Third, a lot is legally possible within EU law when there is political will.** The ease with which SURE and the Recovery Instrument have been set up indicates that there is ample scope within the EU treaties to set up sizeable grant and, more importantly from an ESM perspective, loan support schemes. Together, the loan schemes alone have a capacity of €460 bn, higher than the ESM's current remaining lending capacity that stands at €410 bn.

If the Eurogroup takes these lessons seriously, it cannot just pursue the ESM reform as if the last few months simply never happened. **There is no point in reforming a mechanism that has proven politically unviable with measures that do not address its central shortcoming:** If already the new ESM Pandemic Crisis Support, which had no strings attached, has sparked zero interest, a revamped precautionary lending instrument with tight ex ante conditions certainly will not. If there is serious stigma attached to ESM programmes, giving ESM staff a stronger role so as to signal tougher oversight will be equally counterproductive.

Continuing down yesteryears path would push the ESM further towards irrelevance. That would be a pity for an organisation that has considerable financial firepower and that has built up a formidable staff with deep expertise. Therefore, in the coming weeks, the Eurogroup should save the one part of the reform that is still acutely needed: The backstop function for the Single Resolution Fund. Now more than ever, we cannot exclude a systemic banking crisis in the near future and Europe needs to prepare for it. At the same time, it should throw away the rest of the reform and go back to the drawing board. **To remain relevant, the ESM does not need reform; it needs to become something new.**

3. What a reinvention of the ESM could look like

The ESM was created in 2012 as an international organisation outside the EU legal framework. At the time, this construction represented a conscious design choice underpinned by three considerations. First, setting it up inside the Union was politically challenging because of UK opposition. Second, it was considered legally difficult to set up a support mechanism for member states within the confines of EU law. Third, making the ESM an intergovernmental construct came with the advantage that every member state would have a veto – which was very convenient for those member states like Germany, the Netherlands or Finland, that were absolutely certain they would never ever have to turn to the ESM for help.

Today, the world looks very different on all three accounts. The UK is no longer an EU member. The way in which the EU could set up loan support schemes with a similar lending capacity to the ESM in the matter of just a few months casts doubts about the validity of the legal argument underpinning the ESM's genesis. And the fact that the ESM is seen as a mechanism that is controlled by a handful of member states that will likely never use it is precisely what renders the ESM politically unviable.

Placing the ESM *outside* the EU legal framework has become an unnecessary liability. Consequently, a reinvention of the ESM should start by putting it *inside* the EU legal framework.

The aim would be to finally create a coherent crisis management framework that is politically viable and economically sensible. It should shield member states whose market access is under threat; it should set the right incentives for countries to prevent such situations and to protect them early enough should they nevertheless occur; and it should ensure that the EU has the necessary firepower to fight financial crises of a systemic nature.

Such a reinvention should have **three components**:

- **First, the ESM's tools should be put inside the EU legal framework under a new name.** All EU loan support programmes – former ESM credit lines, the SURE programme, the loan compartment of the Recovery Instrument (RI), the balance-of-payments facility for non-

Eurozone countries, and the SRF backstop – should be consolidated under the roof of the Commission into a single structure with a coherent offer of different credit lines for different needs and sets of strings attached. These rules could still include some of the elements different groups of member states had liked in the ESM reform, such as the introduction of single limb CACs and a clarification – not a tightening – of the access criteria for precautionary lending instruments. For all instruments, the Council should decide on the granting of loans by qualified majority, as is the case for SURE and for the RI loans.

- **Second, the capital paid into the ESM should be transferred to the EU and become the guarantee stock for the loan support programmes.** If necessary, to reach financial firepower akin to today's ESM member states could in addition give guarantees as they did for SURE or grant additional EU budget headroom as was done for the RI. Outstanding ESM loans should be taken on the books by the EU, thus further increasing the universe of EU bonds available as safe assets.
- **Third, the ESM as an organisation should become the EU debt agency** under the auspices of the Commission and responsible for managing the EU's outstanding debt stock. ESM staff have by now ample experience with issuing debt and maintaining investor relations thus complementing the lack of Commission expertise in this department.

Such a reinvention would do away with ESM-specific stigma. It would create one coherent decision-making structure for EU loan support under the political responsibility of the Commission while eliminating national veto threats. It would create a single accountability obligation toward the European Parliament instead of dozens of very uneven national procedures of very different quality and intensity. In short: It would make **EU loan support politically and economically viable in the long run.**

4. How reinventing the ESM would impact Eurozone architecture

Putting the ESM inside the EU legal framework would **shift the institutional centre of Eurozone governance back where it belongs:** The common institutions.

It would of course primarily **strengthen the Commission.** It would no longer act as an agent of member states when negotiating and overseeing adjustment programmes, but as an institution in its own right with its own accountability towards the European Parliament. It would also put a much stronger burden of justification on the Commission for the way it designs and executes the programmes. So far, it could conveniently hide behind the Eurogroup. This would **substantially increase the transparency and legitimacy of European economic governance.**

Such a reinvention would also **strengthen the Council** as it would effectively make the Eurogroup redundant. This would be the logical conclusion of a development that took hold after the Brexit referendum: Then, member states started to meet in “inclusive format”, i.e. including non-euro countries but without the UK, to discuss the future of economic and monetary union. Since the UK left, the Eurogroup in inclusive format and the ECOFIN Council of finance ministers are the same. All relevant decisions in recent years, including the original ESM reform, were taken in that format; the decisions in the pandemic were even taken directly in the European Council and ECOFIN with Eurozone bodies being completely left out of the loop. The Eurogroup failed to make itself useful in this crisis; that it would be dissolved alongside a reinvention of the ESM within the EU would be a welcome efficiency gain.

In a broader sense, moving the ESM inside the EU legal framework would be testament to the fact that, **without the UK, the Eurozone in-out dimension is no longer a relevant fault line** on economic governance questions. Coalitions now routinely include ins and outs. It makes only sense that this is reflected in the institutional setup.

Finally, **the ESM was never about stabilisation, but about crisis management.** It intermittently aspired to become a Eurozone treasury, but [these ambitions were never realistic](#). As a consequence, the reinvention outlined above would provide the EU as a whole with a coherent crisis-management framework; it would not provide the Eurozone with a much-needed fiscal stabilisation counterpart for the ECB. This remains an open flank of the Eurozone that continues to require a Eurozone-specific solution. As a matter of fact, the Recovery Instrument may provide a more useful template for such a project than the ESM, thereby also creating a clear delineation between stabilisation and market-access instruments.

5. Way forward

The Commission should take the opportunity of the upcoming debate on ESM reform and **revive its proposal for a European Monetary Fund from 2017**. It should amend the proposal to reflect the changes outlined above; in particular, the proposal at the time stopped short of changing the decision-making rules, which would be a mistake.

In the event there is political agreement on the direction of travel but negotiations on details prove difficult and would jeopardise the timely introduction of the backstop before the crisis, the Commission could propose a temporary credit line from the EU budget to the SRF to foreshadow the future steady state. This would ensure that the SRF would be fully equipped to weather a possible systemic crisis resulting from the economic fallout of the pandemic.

Of course, there is also a good chance that member states will not consider any bold steps to alter the crisis-management framework at this point in time and will just adopt the reform as if nothing happened. But at least they cannot then argue that there is no alternative.

This publication is part of the research project “Repair and Prepare”, a joint project of the Bertelsmann Stiftung and the Jacques Delors Centre.

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