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The European (In)stability Mechanism

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The European Stability Mechanism (ESM), the eurozone's permanent bailout fund, is in need of reform. But agreeing the next steps has not been smooth sailing, forcing the issue to the top of the agenda of this month's European Summit.

A new ESM treaty, agreed by the eurogroup in mid-June, looks unlikely to be signed by the end of the year due to growing opposition from Italian politicians since November. Their concerns focus on a lack of risk-sharing in the new mechanism.

The ESM was established in 2012 by an inter-governmental treaty among Eurozone countries with the aim of stabilising the eurozone during times of market turmoil by providing financial assistance to states experiencing financing problems. The assistance comes in various ways, including the disbursement of loans at subsidised interest rates, support for government bond issuance and direct recapitalisation of systemically important credit institutions.

To date, the ESM has been involved in the bailout of Cyprus, Greece and the Spanish banking system. It has also taken over from the temporary European Financial Stability Facility (EFSF), which previously granted aid to Portugal, Ireland and Greece as well.

On closer inspection, however, there are so many hoops through which member states must jump that it is unclear if the mechanism is really encouraging stability in the euro area.

For example, ESM membership is not available to countries that have not signed up to the fiscal compact, a European budgetary pact that establishes the procyclical percentage-of-GDP rules that govern public spending. It is also only available to those countries that abide by standardised two-limb collective action clauses (CACs) in their government bonds covenants -- a rule that is supposed to make debt restructuring easier. Finally, strict conditionality is attached to whatever financial assistance plan granted by the mechanism and may be more imposing than Eurozone eligibility outright.

And as Greece knows only too well, how these conditions apply in practice also depends entirely on a country's standing in Europe.

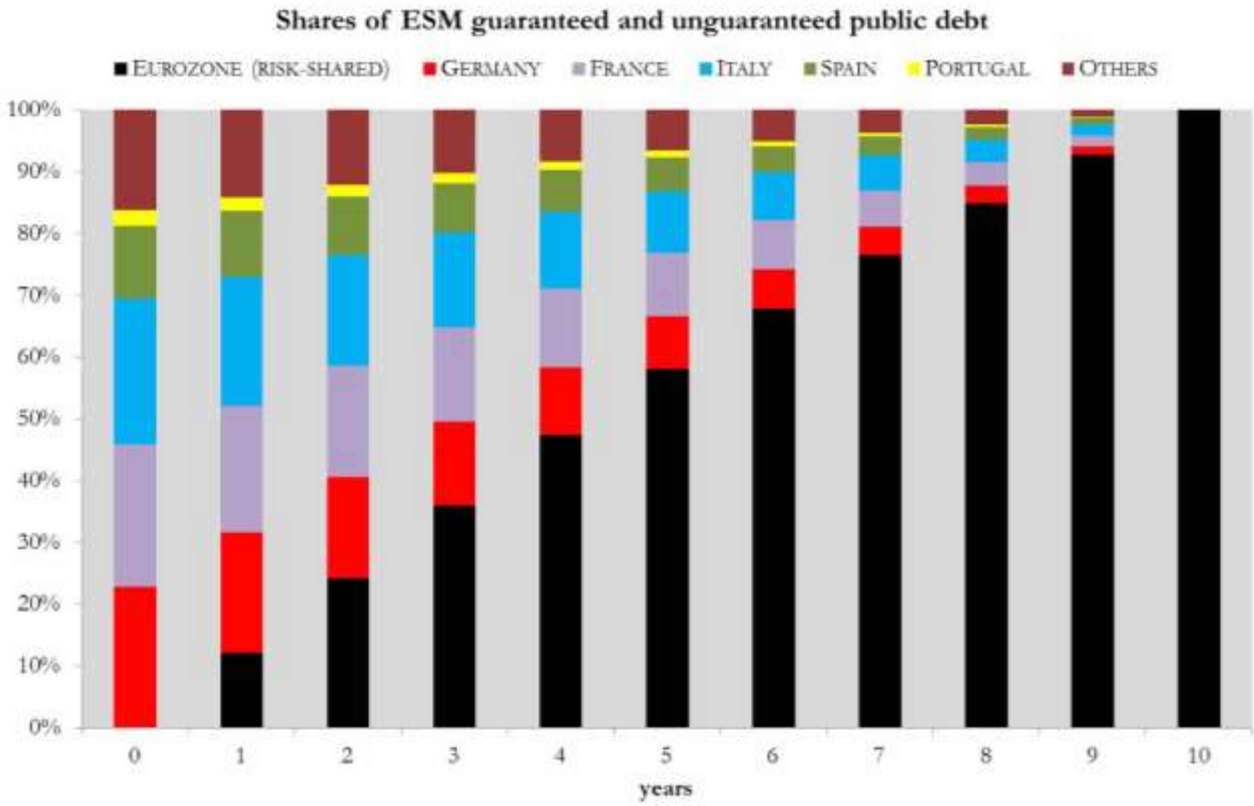
Other flaws include the ESM's undemocratic governance system, with only Germany, France and Italy given a veto; unbalanced capital composition (only 11 per cent of the subscribed capital is already paid in, the remainder takes the form of callable shares); and a sort of self-financing paradox which sees countries applying for stability support not being exempt from capital contributions.

All of the above maintains risk within individual member states, in line with ECB bond-buying where the sharing of hypothetical losses among central banks of the Eurosystem is limited to a mere 20 per cent of government bonds purchased. (The remaining 80 per cent of security purchases are conducted directly by national central banks and transferred on to their balance sheets. The risk of losses is thus borne largely by the national central banks in question).

Myself and other colleagues have argued for ESM reform to be based on more sovereign risk-sharing across the euro area. This, we believe, is the only true way to minimise the aggregate risk posed to the euro area as a whole by weaknesses in individual member states infecting the region at large.

Such risk-sharing could be accomplished by the gradual introduction of an ESM supranational guarantee on the public debt securities of member countries. Hence, if a sovereign issuer was not able to fulfil its payment obligations, the ESM would step in to make the payments to bondholders instead (albeit with the right of recourse against the issuer).

Our proposal foresees two sequential stages. In the first stage, the ESM would guarantee an increasing share of the public debt of each member country: expiring government bonds would be rolled over with the issuance of guaranteed bonds year-by-year until (approximately 10 years later) all outstanding debt was backed by the ESM, as per the chart below:



During this time markets would gradually update their risk perception on the degree of risk sharing within the euro area and resume convergence trades on government bonds of the member countries (ie sell those issued by core states and buy peripheral instead). Specific covenants would contain moral hazard, including the payment of insurance premiums to the ESM by those countries whose sovereign risk exceeds the average of the euro area, with clear limits on public spending and a prohibition to re-denominate ESM-guaranteed securities from euros into another currency.

The second stage – which would take over 10 years – provides for the gradual replacement of ESM-guaranteed debt into ESM-issued debt in order to achieve full mutualisation of sovereign debts in the long run (ie the creation of eurobonds).

Unfortunately, the June draft does not move in the direction of adopting such a risk-sharing approach at all.

Instead the draft contains only a few novelties moving in the direction of improved eurozone resilience.

These apply mainly to the banking system, since the treaty dictates the ESM should act as a common backstop to a Single Resolution Fund, which is the EU private supranational fund charged with providing resources in the context of a bank's resolution after the depletion of all other options (eg bail-in).

Such a backstop would have a firepower of about €60bn and is envisaged as being enforced at the latest by January 1, 2024. In case of early introduction, the backstop would be accessible only to beneficiary banks which have successfully reduced risk exposures, notably non-performing loans. Other risky exposures such as the large dissemination of illiquid securities featured by central-northern Eurozone banks would still be disregarded.

As for sovereign States, the draft treaty strengthens the relevance of countries' debt sustainability and repayment capacity assessments in the decision process on granting precautionary financial assistance.

These assessments (currently carried out by the EU Commission in liaison with the ECB) would require the active participation of the ESM in its capacity as creditor.

In addition, depending on the specific credit line (either "precautionary" or "enhanced") that they get access to, the recipient countries would also have to fulfil eligibility criteria that include, inter alia, a country-specific minimum benchmark for the structural budgetary balance, a calculation which relies on an output gap estimate (which is the difference between potential and actual GDP and whose estimation methodology is much debated among experts).

The main other novelty is the move from two-limb to single-limb collective action clauses (with effect from January 2022) with the aim of making the restructuring of sovereign debts more ordered and predictable, hitherto a delicate process. The rule intends to replace automatic restructuring schemes which have been deemed unacceptable by Southern European countries.

The following table highlights the main differences:

Debt Restructuring Approval Procedure – Cross Series

	2012 Treaty (two-limb CACs)		June 2019 new draft Treaty (single-limb CACs)	
	Meeting	Written Resolution	Meeting	Written Resolution
Quorum	66.7% of the outstanding principal of the affected series	—	—	
Threshold for approval	75% of the outstanding and represented principal of **ALL** affected series	66.7% of the outstanding principal of **ALL** affected series	66.7% of the outstanding principal of **ALL** affected series	
	66.7% of the oustanding and represented principal of **EACH** affected series	50% of the outstanding principal of **EACH** affected series		

The clauses, however, are still up for debate.

As the proposed treaty stands, if financial turmoil hits a member country, the sovereign will have two options. First, to apply for the ESM support. Second, to exit from the eurozone and re-denominate its assets and liabilities --- and hence also its public debt -- into a new currency.

A move to a framework that simplifies restructuring, as this treaty does by introducing the single-limb collective action clause, hence also increases redenomination risk and thus eurozone instability. For that reason alone, it should not be included in the working agenda of a treaty that aims to encourage resilience.

For Italy, recent wobbles in the country's sovereign yields and credit default swaps create a situation where the new draft treaty as it stands could theoretically increase instability in its financial system rather than reduce it. That alone justifies Italian politicians' obstructive stance at last week's European Summit, resulting in the treaty's ratification being pushed back to at least June 2020.

In that time, it would be wise for Italy and other peripheral countries to lobby to ensure stricter rules are only accepted if they come with concrete progress on more risk sharing within the euro area. Without a risk-sharing policy, the euro remains a currency without a state and every state remains trapped by a fiscal framework dictated from Brussels. The time has come to complete the fiscal architecture that underpins the single currency area.

For its part, in order to reduce its vulnerability as a sovereign issuer, Italy should establish a public debt agency similar to Germany's Finanzagentur. The agency temporarily retains government bonds that are not successfully auctioned off by way of the Bundesbank and in so doing minimises the yield spreads between primary and secondary markets.