Social Europe

Forging An ESM 2.0 To Reach A Proper Fiscal Union

by Marcello Minenna on 1 February 2018

After the controversial *European Monetary Fund* (EMF) proposal by the European Commission of December 2017, it's clear that the debate about the future role and structure of the European Stability Mechanism is not over. It will only end when the Euro area benefits from a unified government bond market with a single risk-free yield curve. This will not be easy to achieve while respecting what markets think of the sovereign risk of peripheral countries, but it can be done. The road is not, however, the EMF envisaged within a plethora of proposals from the European Commission. The first, fundamental step would be certainly to transform the European Stability Mechanism (the *bailout* fund established in 2012) but into an insurer of last resort for the public debt of all Eurozone countries.

These are the key features of my idea. Riskier members of the reformed ESM should pay insurance premiums, that would increase the fund's capital by many orders in comparison to the current level of €80billion that is inadequate to bail-out even a large-sized economy like Spain, and would boost its investment capacity. The more the sovereign risk of a country, the higher the premium to be paid. It's not rocket science, but a simple, effective mechanism that resembles the functioning of a classic derivative instrument, the *Credit Default Swap*. Using more technical jargon, the premium is needed to hedge the difference between the credit risk of the different Member countries and the Eurozone average. An appreciable feature of this mechanism would therefore be the fact the size of the insurance premium would be determined by market evaluations of credit risk so far from being driven by strong political influences.

The process of insuring debt should happen gradually; as the old bond issues of each government come to maturity, the ESM would substitute them with new tranches of a common guaranteed Euro area debt. After completing this operation of *risk-sharing* (not less than ten years, according to my estimates), Eurozone countries would no longer be allowed to issue public debt independently from this common ESM issue program. Or, putting it another way: at the end of this sequence each Eurozone country would give up its fiscal autonomy in exchange for a full mutualization of its past government debt.

In the 10-year long process of transition, indeed, premiums paid for the ESM guarantee represent a shield against potential fiscally irresponsible behavior of a "free-rider" country. The contribution scheme in fact would discourage reckless fiscal policies, because it's understood that more debt would mean more credit risk to be insured and then it could be issued only with higher contributions to the reformed ESM.

Real Economy Investments

In normal times, the proceeds of the reformed ESM would be invested in the real economies of Member States. Again, it would be useful to use an intuitive criterion of proportionality: higher premiums should guarantee a greater quota of investments. The ESM's financial backing would be granted only to highly profitable projects. In this perspective, fixed capital formation has the highest multiplier across all components of public expenditure, especially if concentrated in high-potential, but depressed areas like southern Italy. Obviously, there would be a problem of accountability related to investment management activities (selection, administration, revision). This could be addressed by transferring all powers to a supranational, independent institution (e.g. the European Fiscal Board) with a neutral view based only on objective economic indicators of profitability.

By construction, this design of a reformed ESM will produce a convergence of government yields towards a single curve for the entire Eurozone in a form even stronger than the one experimented with in the first years of life of the Euro (until the crisis of 2007-2008). In fact, a fully mutualized debt naturally implies a homogeneous credit risk evaluation, since national public debts would eventually disappear and merge within a Eurozone one. In this way we will enjoy the re-birth of Eurobonds, even if in a synthetic form, managed by a reformed ESM that would accordingly assume many of the powers of the current Ministers of Finance of the Member States and would make the proposed reform of the European Commissionreadily obsolete.

To conclude, I'm supporting a radical proposal, "peripheral-friendly" of course, but one that is respectful of market evaluations and that moves towards a federalist Europe. An ESM 2.0 based on risk-sharing, a single yield curve and the rebooting of fruitful public investments with a higher degree of flexibility than today could form the skeleton of a future federal budget that can rely on the possibility of issuing Eurozone supranational bonds.

This concrete, market-based concept represents an alternative to the German proposal of transforming the ESM into a severe fiscal authority independent of political bodies and inserting creditor participation clauses within the government bonds of the different member states.

Obviously, this would have a major impact on current Eurozone financial infrastructures. The EU institutions should support the process of convergence with various other measures: for example, in the early years, the architecture of the Fiscal Compact should be properly harmonized to exclude the premium paid to the reformed ESM from the calculations related to the structural balance. In the end, with a mutualized debt, the same Fiscal Compact regulation would not be needed anymore. Moreover, ECB support should be guaranteed through the prosecution of its asset purchase programs for a reasonable extended timeframe.

Of course, it may not be politically feasible given the current circumstances that are pushing in the opposite direction towards a segregation of risks within each country of origin. This process is on *stand-by*¸ waiting for the results of Italian elections, but it will restart in full force immediately after they take place. However, recent developments do not make me optimistic about the future of the Eurozone integration process: the proposal for European Safe Bonds is gaining a lot of traction but it's not that brilliant an idea – these are fake Eurobonds without any real risk-sharing between Member countries and pose more problems than they solve…

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