



How to fix the ESM

Bailout fund should guarantee all EU government debts but charge a protection fee, writes Marcello Minenna

As the end of Europe's quantitative easing programme approaches, Germany is seeking to immunise itself against the possible reignition of sovereign risk in the southern eurozone countries.

It has proposed to reform the European Stability Mechanism (ESM) – the permanent bailout fund for eurozone countries – to become like a European version of the International Monetary Fund, replacing the European Commission as the enforcer of the rules set out in the stability and growth pact and the fiscal compact.

But this anachronistic and misleading idea of a monetary union, where risk reduction is pursued through segregation within 'rogue' countries, doesn't fit with the general theory of optimal currency areas, which, instead, recognises that risk sharing on public debts is a necessary condition for achieving widespread financial stability.

An alternative to Germany's plan would see the ESM as a guarantor of debts across all its members, with the costs of this protection met by those who use it most. It would align economic cycles across the eurozone, increase government bond liquidity and cut the amount of paid-in capital required from the richer nations.

Current problems

The ESM was established by an intergovernmental treaty in October 2012 as a permanent bailout fund for eurozone countries. So far, it has been involved in the management of relatively small crises: the indirect

recapitalisation of Spanish banks and financial assistance programmes to Greece (still ongoing) and Cyprus (now closed).

But the mechanism is only a theoretical umbrella against huge shocks affecting any major economy of the euro area. To understand why, we need to examine the capital structure, the decision-making process and the equity composition of the ESM.

The capital key is similar to that of the European Central Bank (ECB), with Germany being the largest contributor in terms of paid capital and contingent future commitments. As a consequence, Germany holds *de facto* control over the ESM, which it has regularly exercised by dictating the conditions under which the mechanism has granted its assistance to beneficiary countries.

Should its conditions be rejected, the German government could veto the main decision by exercising a right that it retains – along with France and Italy – even in the emergency decision-making procedure. And, obviously, the odds that Germany would block any aid to a too-big-to-save country such as Italy are high.

The current equity composition of the mechanism could also create serious problems if it was activated in the rescue of a large sovereign issuer. The ESM has subscribed capital of €704.8 billion (\$820 billion), of which only €80.55 billion is already paid in; the remaining €625 billion are callable shares that members could be required to pay upon request of the ESM board of governors.

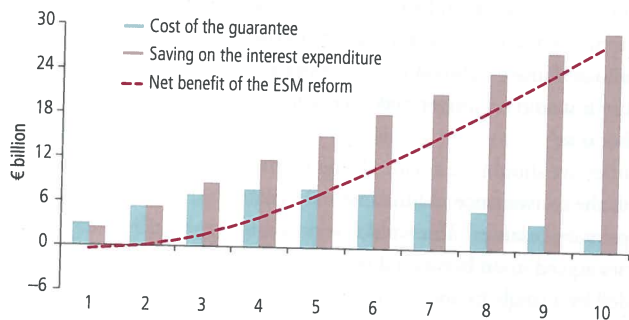
Hence, additional cash contributions are exposed to the risk of one or

A. Estimated impact of the reform on the interest expenditure of the eurozone countries (€bn)

Country	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Germany	1.8	3.2	4.2	5	5.7	6.3	6.9	7.4	7.9	8.3	56.8
France	1	1.7	2.1	2.3	2.3	2.1	1.9	1.5	1	0.4	16.3
Italy	0.5	-0.1	-1.6	-4	-7.2	-10.8	-14.7	-18.8	-23.1	-27.7	-107.4
Spain	-0.4	-1.1	-2.1	-3.5	-5	-6.7	-8.5	-10.4	-12.4	-14.5	-64.4
Portugal	0	-0.2	-0.5	-1	-1.5	-2.1	-2.7	-3.3	-4	-4.7	-20
Austria	0.2	0.3	0.3	0.4	0.3	0.3	0.3	0.2	0.2	0.1	2.7
Netherlands	0.3	0.5	0.7	0.8	1	1.1	1.2	1.3	1.3	1.4	9.6
Belgium	0.2	0.3	0.3	0.2	0.1	0	-0.1	-0.3	-0.4	-0.6	-0.2
Finland	0.1	0.2	0.3	0.4	0.4	0.5	0.5	0.5	0.5	0.5	3.9
Ireland	0.1	0.1	0.1	0.1	0	-0.1	-0.1	-0.2	-0.2	-0.3	-0.5

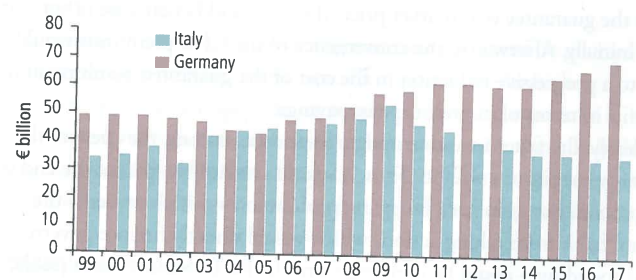
Source: Author's calculations based on market data

1. Cost-benefit trade-off of the reform: the case for Italy



Source: Author's calculations based on market data

2. Public sector: Gross fixed capital formation at current prices: 1999–2017



Source: Ameco, the annual macro-economic database of the European Commission's Directorate General for Economic and Financial Affairs

more non-compliant countries, leading to possible cash imbalances that could paralyse the mechanism at times of greatest need.

Risk sharing to the rescue

Over the past few months, I have developed an alternative reform proposal for the ESM that would result in an indirect mutualisation of public debts, remove the above-mentioned architectural distortions and sow the seeds for carrying forward the creation of a federal budget and a unique European finance minister.

The new ESM – with a more democratic governance – should become the effective guarantor of the public debts of all its members. This could be achieved gradually within a 10-year horizon: each year, maturing government bonds would be replaced by new securities embedding risk-sharing clauses, which provide for the joint liability of all governments, making perfect substitutes for the bonds issued by different sovereigns.

It would be like a credit default swap (CDS) deal where the riskiest countries buy protection from low-risk ones. The diversifiable risk would be borne by the ESM, and therefore the public debt would remain exposed only to the non-diversifiable risk, namely that which is inherent in the eurozone as a whole.

In exchange for the protection received, the most risky countries – such as Italy – would be called to pay annual cash contributions to the ESM for an amount equal to the market price of the guarantee. Net protection sellers such as Germany and France, on the other hand, would be exempt from future payments.

Such a revision of the contribution scheme would discourage reckless fiscal policies because more debt means higher contribution charges. In order to further encourage responsible budgetary policies, new securities issued by supporting euro area countries to contribute to ESM capital should be accounted for in their national public debts. This will remove the exemption that currently prevents these contributions from impacting government accounts.

A not-insignificant advantage of the proposed revisions would be a closing of the gap between paid capital and subscribed capital of the ESM. Based on some simulations, the increase in paid capital would be between €70 billion and €100 billion in total, of which about 80% would be charged to Italy.

The transition to a wider availability of cash capital is obtained at the price of significantly reducing the aggregate subscribed capital of the mechanism, from €704 billion to less than €200 billion. This would come with a saving of funds for all members with respect to the current potential commitment through callable shares.

The new contributory scheme would change the share of the various countries in the ESM capital base, which would favour the transition to a more democratic governance. Germany would need to give up its veto, but in return it would not be required to make any further disbursements – today it is running a contingent liability worth €169 billion.

As for Italy, we are talking about €70 billion to shell out in 10 years – which, frankly, is acceptable in return for substantial savings in interest expenditure.

Indeed, the reform would cause a clear-cut reversal of the risk attitude of financial operators with respect to countries with high debt burdens. Convergence trades, such as those that occurred in the late 1990s, would accelerate the transition to a new regime featuring a unique yield curve across all eurozone states. In addition, the 'announcement effect' associated with such a reform would improve the ability of countries such as Italy and Spain to face the normalisation of the monetary stimulus recently decided upon by the ECB.

Over the phase-in period, the insurance price paid by risky countries would depend on two opposite forces: the increasing quantity of risk-shared debt; and the decreasing sovereign risk premium required by markets. Initially, the first force would prevail, but after a few years the second would become dominant, defining an inverted U-shaped pattern. Figure 1 shows this pattern in the case of Italy.

To get a comprehensive idea of the cost-benefit trade-off of the proposed reform, figure 1 also displays the saving on interest expenditure with respect to the status quo scenario and the net combined effect of the two factors.

As the guarantee is at market price, the costs and benefits are offset – at least initially. Afterwards, the convergence of the CDS premiums would lead to a progressive reduction in the cost of the guarantee, resulting in net benefits in terms of interest expense savings.

Clearly, the faster investors update their expectations, the cheaper the convergence process will be. Thus, it would certainly help if, at the end of the process, the monetary financing prohibition – which prevents the central bank from taking actions which would directly finance government spending – could be removed from the ECB's statute: once public

debts are fully mutualised, the prohibition would no longer have any reason to exist.

Of course, Germany and some of its neighbours would experience a deterioration of their creditworthiness because of the joint responsibility on the shared debt of the other states. But in return they would benefit from that precious public good that is financial stability.

Table A shows an estimate of the proposed reform on the interest expenditure of individual states. For countries that are net protection buyers, the data also includes the cost of the ESM guarantee.

Germany and France would be the most-affected countries in terms of higher interest expenditure, while Italy would obtain savings of more than €100 billion. It would be a complete reversal of the data recorded over the period 2007–2016, during which time Italy had to pay €150 billion more on interest expenses than Germany, despite their public debts being of the same order of magnitude.

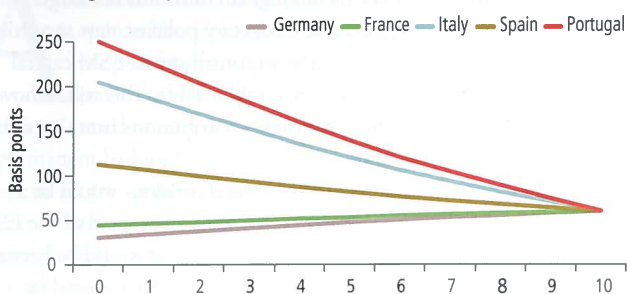
Other positive effects

The advised reform would also deliver several positive side-effects. Like the monetary financing prohibition from the ECB, the so-called no-bailout clause enshrined in the European treaties should be removed, because it would no longer make sense to speak of a country that saves another one.

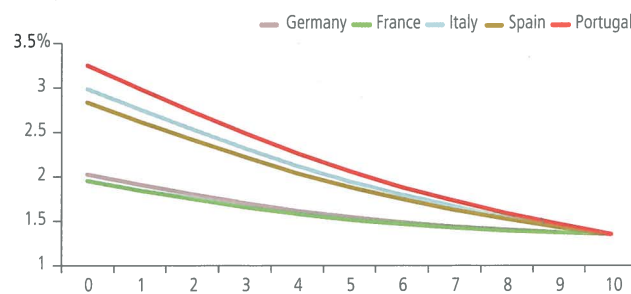
Rather, we should see a natural alignment of the economic cycles, as well as the convergence of fundamental variables such as inflation, growth and primary balances. This would be driven by appropriate budgetary policies agreed upon between different governments – or even centrally decided by a single finance minister who, frankly, would otherwise have

3. Estimated impact of the reform on CDS spreads, average coupon, primary balance and growth

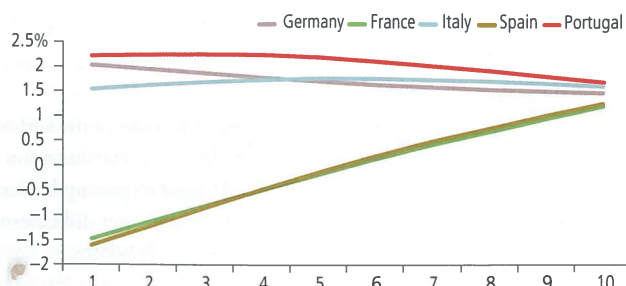
Sovereign CDS premium



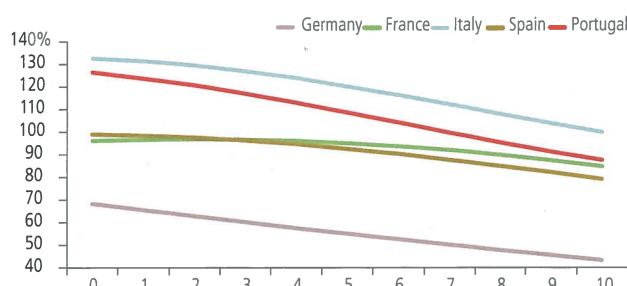
Average coupon



Primary balance

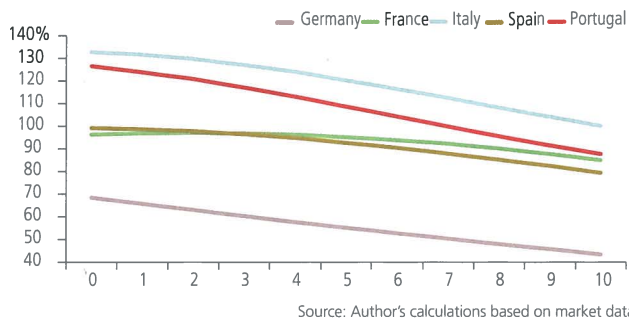


Nominal growth



Source: Author's calculations based on market data

4. Estimated impact of the reform on the debt-to-GDP ratio of selected eurozone countries



little reason to exist. Meanwhile, the no-bailout clause could be interpreted with a bit more elasticity than the past.

The controversial issue of introducing risk weights on government bonds would also become obsolete, because the causes of the home country bias that fuelled the debate would shatter. And, unlike other proposals such as those for European Safe Bonds, where a supranational institution like the ESM would buy eurozone government bonds and issue tranching asset-backed securities to investors, the bank-sovereign doom loop would be solved once and for all.

A further benefit of risk sharing would be the upgrading to a much wider and more liquid market of public debt securities than today, and thus also more competitive on international financial markets. This is because it is one thing to finance the public debt of a specific member country; it is another to finance the public debt of the entire eurozone area. From this perspective, governments would also be able to attract more capital with a view to improving the competitiveness of the euro against the US dollar. And the more capital you attract, the more funds are available to finance new investments, which boost productivity.

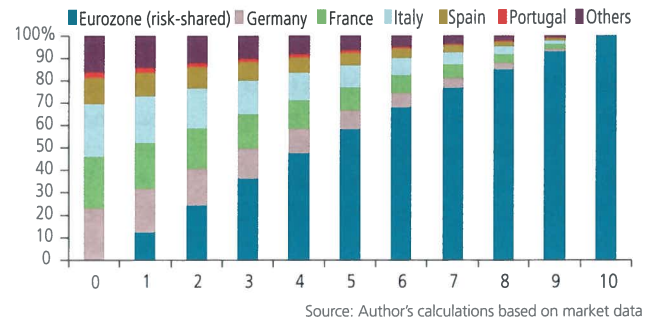
ESM leverage

The final chapter of my proposal addresses the relaunch of public investments in southern eurozone countries, where fiscal discipline has fostered a significant decoupling of expenditure for gross fixed capital formation with respect to northern Europe.

To restore a more balanced situation across economies that share the same currency, the evident procyclical implications of excess austerity should be removed. A joint revision of the ESM and the fiscal compact could introduce flexibility clauses that allow national governments to deviate from the constraints on public accounts in order to let them finance new investments for an amount corresponding to the market price of the guarantee on the public debt. This would have a redistributive effect on the public expenditure for investments favoring the realignment across countries.

Targeted support could also be provided by the ESM. Today, its liabilities are broadly the same amount as the paid-in capital. Keeping leverage unchanged at today's moderate level, the mechanism could raise liquidity on the markets to back up investments of

5. Evolution of risk-shared and non-risk-shared public debt over time



member countries, according to a mirroring scheme similar to that used to support the Greek auctions. In this case, ESM auctions were purposely scheduled to ensure that the mechanism had the liquidity to buy Greek government bonds, which allow it to keep Greece's primary market funding costs under control.

This time, however, the ESM's financial backing would be granted to highly profitable projects. Fixed capital formation has the highest multiplier across all components of public expenditure, especially if concentrated in high-potential development areas as southern Italy. In order to preserve quality and efficiency, a special EU committee could select the best projects and monitor all stages of their implementation.

Possible outcomes

Figure 3 shows the estimated average patterns of CDS spreads, sovereign coupons, primary balance and nominal growth.

No wonder we can see the convergence shown in the charts. By assuming the risk sharing of the entire public debt in 10 years – through its progressive consolidation into the ESM – the model naturally leads to the convergence of these magnitudes.

As for the debt-to-GDP ratio of the new eurozone, at the end of the convergence period its value will approach the 60% threshold required by the Maastricht treaty. Looking at the pattern of this ratio for the individual states, it turns out that even the so-called sick countries of Europe, such as Italy, would fall below 100% in 10 years (figure 4).

In any case, it has to be considered that such detail loses significance in the new setup. In fact, as time goes on, the portion of the eurozone's public debt attributable to the individual states (that is, without risk sharing) will decline progressively, and in the tenth year all public debt will be shared (figure 5).

An 'ESM 2.0' based on risk-sharing, a unique 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 is a concrete, market-based proposal. It represents an alternative to the German option 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. ■



Marcello Minenna is a PhD lecturer at the London Graduate School of Mathematical Finance. He can be contacted at M.Minenna@lse.ac.uk