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ESM reform

No need to reinvent the wheel

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In this blog post, Lucas Guttenberg argues that the ESM does not need a new instrument to provide short-term liquidity to member states. Instead, finance ministers should clarify that some of the existing instruments can be used without recourse to a full adjustment programme, i.e. based only on ex-ante eligibility criteria.

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The debate on reforming the European Stability Mechanism (ESM) was triggered when it became clear that using the ESM as a backstop for the Single Resolution Fund (SRF) would make it necessary to change the ESM treaty and hence this would be an opportunity to change the setup of the ESM at large.

By December this year, euro area finance ministers will have to come up with a term sheet on how to reform the ESM. Their job, as determined by their bosses at the June Euro Summit, is to discuss "all elements of an ESM reform" as outlined in the letter by the Eurogroup president and to agree on a package for the way forward.

The letter mentions roughly four loosely-linked strands that I have discussed in detail here: First, the modalities of using the ESM as SRF backstop; second, the role of ESM staff in crisis management; third, rules to deal with unsustainable debt; and, fourth, possible new lending instruments.

In this blog post I will concentrate on the last element: **Does the ESM need new instruments?** This question is currently debated at technical level in Brussels but will resurface in the political realm the latest by December. I will argue that **instead of conceiving new instruments with doubtful added value, finance ministers should clarify conditions of existing instruments** to ensure that they can cover all instances of liquidity needs by member states. In particular, they should **be clear that some ESM instruments can be used solely on the basis of ex-ante eligibility criteria** without a full programme.

1 The access-to-liquidity gap in the ESM toolbox

A number of observers (see e.g. Enderlein et al here or Claeys here) have pointed to a gap in the current crisis management toolkit of the euro area: For **countries that have strong fundamentals and are in principle solvent but that come a under substantial liquidity strain** (e.g. due to contagion), there seems to be no clear European instrument to turn to. So far, all instruments that are available in the ESM toolbox are interpreted as necessitating some form of adjustment programme that requires lengthy negotiations with euro area partners and come with considerable stigma, i.e. political costs for the asking government. This is particularly unappealing for countries that have just exited an adjustment programme and will do everything to avoid going back. On top of that, the ECB has made clear that its Outright Monetary Transactions (OMT) can only be deployed in conjunction with an ESM programme.

Views may differ whether this gap is real, but the recent episode of government formation in Italy was a good example of the danger that comes with a perceived incomplete lending toolbox: Portugal and Spain faced funding increases even though their fundamentals had remained unchanged. These countries would have avoided at all cost falling back into a programme yet again. Had their financing situation deteriorated, it would have been likely for them to wait too long before asking for help, which would have increased the eventual costs substantially.

Proposals are now abound for how to fill this **perceived access-to-liquidity gap**: a liquidity window to unlock OMT, a pre-earmarked rapid response facility at the ESM, idea to give the ESM access to ECB financing. The German chancellor argued in her famous interview in May 2018 for a short-term liquidity line. And the ESM Managing Director Klaus Regling has argued for new "short term ESM loans."

2 Revisiting ESM conditionality – the only viable option for now

But do we really need new instruments? As discussed above, the lack of appeal of the current toolbox seems to stem from the fact that

a) going to the ESM seems to mean **signing up to an adjustment programme**;
b) accessing ESM funds means **convincing all euro area partners in a lengthy process**; and
c) **OMT cannot be accessed without turning to the ESM**.

Realistically, **the two latter points will not change** in the foreseeable future:

On c), the ECB has made clear that it will not support individual countries without the political cover of finance ministers via the ESM and the European Court of Justice has confirmed the legality of this arrangement.

On b), the debate in recent months has made it very clear that **the governance of the ESM based on unanimity will not change anytime soon**. Germany will want to keep its veto to avoid vexing its constitutional court (and the conservative group in the Bundestag). And because Germany will keep it, so will all the other member states. Many who would like to see substantive EMU and ESM reform will not be happy about this and see it as inadmissible intransigence from Berlin. But this seems to be the political reality for now, and hence proposals that build on a decision-making process that does not at some point include member states' approval are simply not on the cards for the moment. The only exception could be some form of pre-agreement for the use of the backstop for the SRF – but certainly not when it is about supporting governments of individual member states.

This leaves us with changing a), so the current understanding that turning to the ESM automatically means committing to a painful adjustment programme, i.e. for the respective government to sign a political suicide note and for the country to undergo a series of reforms that might not even be acutely necessary from an economic point of view. This, the conditionality required to tap the ESM, is where there is room for manoeuvre – well within the current instruments as we will see below.

3 Why the current ESM toolbox could be enough

The ESM already has two main lending instruments to deal with a country that comes under market pressure but does not have solvency problems: First, the two precautionary lines, i.e. the **Precautionary Conditioned Credit Line (PCCL)** and the Enhanced Conditions Credit Line (ECCL), are designed to assure markets that a country can overcome temporary funding needs should market conditions become difficult. While the PCCL is addressed to fundamentally sound economies, the ECCL is for countries that do not meet all PCCL criteria. Second, the **Secondary Market Support Facility (SMSF)** gives the ESM the possibility to intervene directly in bond markets if they fail to function properly for a certain member state. None of these instruments have been tested so far.

Now, there is reason to believe that **these instruments could already be used without signing up to an adjustment programme**. The ESM treaty states in article 12 that ESM support is granted "subject to strict conditionality". But it also makes clear that "such conditionality may range from a macro-economic adjustment programme to continuous respect of pre-established eligibility conditions."

The guidelines on precautionary assistance and on the SMSF make use of this flexibility in defining conditionality.

Member states can ask for secondary market purchases even when they are not in an adjustment programme and are eligible for a PCCL if they meet the following six criteria and commit to keep meeting them:

- Compliance with requirements under the fiscal rules, even if a country is subject to an Excessive Deficit Procedure
- Sustainable government debt
- Compliance with requirements under the Macroeconomic Imbalances Procedure, even if a country is subject to an Excessive Imbalances Procedure
- A proven track record of market access
- Sustainable external position
- No systemically relevant bank solvency problems

And that's all.

Both guidelines require the conclusion of a formal Memorandum of Understanding (MoU) between the Commission and the respective member state because that is what the ESM treaty requires for all ESM support. But **there is a priori no reason why simply the continuous respect of these six conditions should not be sufficient conditionality** to be specified in the MoU – after all, the ESM treaty explicitly considers "continuous respect of pre-established eligibility conditions" to suffice as strict conditionality. If we take the example of Spain and Portugal from above, both would currently be perfectly compliant with these conditions (in fact arguably all member states except Greece are). So we could conclude that **the ESM already has the necessary tools – they just need to be used**.

4 What should be done?

So why do observers disregard these two instruments and still see a liquidity gap? Most likely because the interpretation presented above is not the only one (even though I would argue it is the most plausible one). **The text of the guidelines and also the presentation by the ESM give rise to constructive ambiguity**. For example, the ESM argues on its website that to access the SMSF outside a full programme, countries would be subject to "specific policy conditions" – whether that means meeting ex-ante criteria or also ex-post conditions is left open. The fact that there is still a need to "negotiate" an MoU is a potential loophole for other member states to ask for all kinds of policy conditions. And after all, it will be the other euro area governments (and sometimes their parliaments) that will decide which interpretation carries the day.

So a very practical step could be to **take the constructive ambiguity out of the system**. The simplest way there would be for the next Euro Summit in December to make a clarifying statement to markets that the PCCL and the SMSF can be used based only on the continuous fulfilment of ex-ante eligibility criteria. But as the ESM treaty will need to be opened in any case for the SRF backstop, it could also be changed to clarify that there is no separate need for a negotiated MoU but just for a commitment by a member state to continue to fulfil the criteria. Such an ESM treaty change could also make sure that the continuous country surveillance by the Commission and Council plus a regular debt sustainability analysis e.g. by ESM staff would suffice as instruments to monitor the eligibility criteria. Finally, it might make sense to be more precise as to how the criteria can be fulfilled: In particular, it is not completely clear what a proven record of market access means and whether this includes countries that consistently have had market access in the past but are acutely at risk of losing it.

Interestingly, **Franco-German roadmap agreed at Meseberg (see here a full assessment) goes exactly in this direction**. It does not speak about a new instrument, but rather about making the precautionary instruments more effective by using "two-fold" conditionality: First ex-ante eligibility criteria and second a formal commitment to respect these criteria.

If France and Germany really mean what they stipulated – especially if the German government were really willing to commit to a use of ESM instruments based only on ex-ante criteria – and can muster the necessary support among the other member states, this would be a major step. It would **make it clear to markets that even without resorting to the ECB and without dooming incumbent governments, the euro area has the right tools already** not to let one of them down when getting hit by markets.

But that is still a pretty big If.

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