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Insight

The European Stability Mechanism is not ready for the next crisis

by Sander Tordoir, 29 November 2022

Eurozone finance ministers just appointed a new head of the European Stability Mechanism (ESM). They should seize the opportunity to turn the ESM into a more useful institution.

As a rapid succession of crises has engulfed the European economy, silence reigns on the Circuit de La Foire Internationale in Luxembourg, home to the European Stability Mechanism (ESM). The eurozone's permanent rescue fund was set up in 2012 to provide loans to financially distressed countries, and today has about €410 billion in lending capacity. It played an important role during the euro crisis a decade ago. But the ESM was left on the sidelines as the eurozone was hit by the pandemic and Vladimir Putin's invasion of Ukraine, with member-states no longer being willing to resort to its bail-out programmes. As the eurozone economy heads for a recession, having a non-functional ESM is risky, because eurozone governments need an emergency lender in the event of a financial crisis, and if they resort to the ESM too late millions of Europeans might be condemned to unemployment. Last week, EU leaders appointed Luxembourg finance minister Pierre Gramegna as the institution's new managing director: he should press them to rethink the ESM's status and purpose. New EU fiscal support instruments developed during the pandemic provide a blueprint for meaningful reform.

The current ESM model is unviable

Cyprus, Greece, Ireland, Portugal and Spain used ESM support during the euro crisis ten years ago. Modelled on the IMF, the ESM can issue loans to distressed EU members, but in most cases the recipient must agree to tighten its budget, carry out structural economic reforms and, where relevant, clean up its financial sector. The specific conditions are negotiated between the European Commission and the member-state concerned, supported by ECB, ESM and possibly IMF staff, on behalf of the ESM's shareholders: the eurozone finance ministers.

The EU's emergency measures during the pandemic suggest that the ESM model is now in trouble. The EU set up a loans scheme – the 'instrument for temporary support to mitigate unemployment risks', also known as SURE – to buttress national unemployment insurance schemes. The €750 billion pandemic recovery instrument, NextGenerationEU (NGEU), uses EU members' joint creditworthiness to raise money for grants and loans to member-states that pledge public investment and structural reforms. European

finance ministers also made ESM credit available with few strings attached: the funds simply had to be used for health expenditures. Countries would pay a broadly similar interest rate for lending from SURE and NGEU, and the ESM. The result: nineteen EU countries used the SURE program to fight the sharp pandemic downturn. All EU countries used NGEU grants, and six countries requested NGEU loans. Not a single country tapped the ESM's support.

The ESM has become the eurozone's fire brigade that nobody calls when the house catches fire. At the beginning of the pandemic governments did not tap ESM support because going through a bailout was too costly politically, and may not have been necessary, but even after they relaxed the conditions, governments were still hesitant to tap a fund they perceive to be run by the most hawkish members of the eurozone. Citizens recognise this: public opinion across Europe is much more positive about the pandemic recovery instruments than they were about the old wrangling between creditor and debtor countries in the ESM boardroom. In the December 2021 Eurobarometer, 77 per cent of eurozone citizens had a favourable view of the EU recovery plan.

Innovations by the ECB have further diminished the ESM's role. Under its 2012 programme, Outright Monetary Transactions (OMT), the ECB can purchase the sovereign bonds of a eurozone member-state under speculative attack from financial markets, if it is in an ESM-supported programme. Yet rather than rely on the ESM-OMT tandem, the ECB has developed new instruments to forestall financial crises.

These innovations are sensible: if anything, the global financial crisis, pandemic and Russian war on Ukraine demonstrate that shocks affecting the EU as a whole are much more prevalent than the country-specific crises – including self-inflicted ones – that the ESM was built for. The Pandemic Emergency Purchase Programme (PEPP) – in which the ECB bought sovereign bonds to stave off financial stress when Covid-19 struck – has no link to the ESM. It was built on the explicit recognition that the OMT was too inflexible and country-specific to tackle a shock that hit all eurozone countries. More recently, the ECB agreed on a Transmission Protection Instrument (TPI) to ensure that borrowing costs in highly indebted countries, especially Italy, do not surge as the ECB raises interest rates to curtail inflation. Strikingly, the ECB's TPI is conditional on beneficiaries complying with EU economic and fiscal rules, including NGEU reform pledges, and not on an ESM programme.

The failure of the ESM pandemic line and the introduction of SURE, NGEU and TPI call into question whether the ESM is still an effective line of defence for the eurozone.

A defunct crisis management instrument is a problem for the eurozone

As the ESM continues to sit idle, the European economy faces an acute energy crisis, which threatens to tip it into recession. High inflation, rising interest rates and a looming recession might reveal lurking weaknesses in a highly indebted and opaque non-bank financial sector, or inflict significant losses on traditional banks. Governments will pay more to finance their debt, and the premium that highly indebted countries pay has risen. The ESM and its €410 billion in lending capacity are the single largest remaining bit of shared European fiscal firepower. The SURE and NGEU instruments are largely already committed, and the latter's remaining capacity will be used to fund RepowerEU, the EU's plan to cut Russian gas imports. The ECB's TPI cannot be used if a country makes egregious policy errors. As risks in the eurozone economy mount, will the ESM be left unusable?

Recent reforms to the ESM, negotiated in 2019 but as yet unratified, would make its financing even harder to access. For example, precautionary credit facilities – which have less onerous conditions and

are meant to avoid the need for a full bail-out programme – would be subject to strict, codified eligibility criteria rather than the judgement of the ESM's board. Very few countries met these criteria back in 2019, before the pandemic and war in Ukraine, let alone today. As a result, member-states that need support will probably not ask for it until it is too late, because the ESM's precautionary lines are unusable. This will make bail-out programmes unnecessarily costly and painful. A more long-standing issue is that the ESM has always been too small to bail out Italy.

The eurozone can reverse these reforms, and go further still. The reformed ESM Treaty is not yet ratified in Italy, where it is too controversial to be brought before parliament, and Germany, where President Frank-Walter Steinmeier has not yet signed it into law while he waits for a judgement by the German constitutional court. As they appoint Gramegna as the new ESM's chief, Europe's leaders should consider bolder reforms so the ESM can help overcome Europe's mounting challenges.

How to bring the ESM in from the cold

The ESM is an intergovernmental institution, meaning that all eurozone member-states must agree to a lending programme. The ESM needs to be brought into the EU framework. This would help reduce overlaps with the European Commission, which also examines member-states' economic policies. It would introduce qualified majority decision-making and eliminate the threat of national vetoes, and it would create accountability to the European Parliament instead of a forest of national parliamentary procedures.

But the improved governance of the eurozone means Europe could be even more ambitious. Here are two ideas to make greater use of the ESM's lending capacity.

The first idea is that the ESM could become the central credit line that would complete missing elements of the eurozone's banking union. This fits with the ESM's official mandate – providing emergency liquidity to countries to safeguard the financial stability of the eurozone.

Under the stalled 2019 reform, the ESM would already provide a backstop to the EU's fund to wind down failed banks, the Single Resolution Fund (SRF), in case it runs dry (the fund is widely considered to be too small). But there is another problem. When a bank is declared failing or likely to fail by Europe's banking regulators, it is either liquidated or put into a resolution scheme. As a new banking entity emerges, and new capital is injected by the SRF, the new bank may initially need more assets as collateral to borrow from the ECB (which requires such collateral by law). A bank cannot operate without liquidity and the SRF is too small to provide the assets needed. So far, this burden has been left to national finance ministries and central banks. This creates a misalignment in incentives between member-states (which have the liability associated with funding the banks, and will try to protect taxpayers) and the ECB (which supervises those banks and will press for big injections of capital). It also strengthens the 'doom loop', in which the balance sheets of banks and national governments are too enmeshed, which plagued the eurozone a decade ago. A European public guarantee for rescued banks from the ESM to the ECB would take national authorities out of the firing line and help sever this link.

The ESM could become the kernel of a European deposit insurance scheme, the key and most controversial element of the banking union, which is still missing entirely. National schemes guarantee that bank deposits up to a certain level will always be repaid to customers even if the bank holding them fails. The approach is harmonised throughout Europe but there is no common fail-safe if governments get into financial distress themselves. The ESM could re-insure national deposit insurance schemes or create a new pooled European scheme to provide more financial stability.

By making the ESM a backstop to the financial sector, the eurozone would move closer to other jurisdictions. The US Treasury provides a liquidity backstop to its banking authorities for both bank resolution and deposit insurance. With this backing, the Federal Deposit Insurance Corporation (FDIC) safely resolved over 500 banks between 2008 and 2011. In the euro area, this number remained stuck at about 50. The result was a recovery hampered by a limping banking sector. Making the ESM the central fiscal backstop for the banking union will prevent the weakness of some banks spreading to healthy ones, and make it less likely that the backstop would be called upon in the first place. The US Treasury's credit lines to its bank resolution and deposit agencies are of a similar order of magnitude to the ESM's lending capacity.

The recent market turmoil in Britain is a warning sign that even countries with seemingly strong bank and sovereign balance sheets must do more to strengthen their financial sectors. It should prod eurozone member-states to move on from their red lines on the banking union.

The second idea: Europe could retain the principle of the ESM as its lender of last resort for governments in trouble, but reform it to make it more effective. A good start would be reversing the 2019 reform, so that member-states could more easily get precautionary credit. Even better would be a bolder reform of the toolkit. Turning the intergovernmental ESM into an EU institution opens such possibilities. Former ESM tools can then be redesigned alongside the loans from SURE, NGEU and the regular EU budget into a set of flexible EU credit lines. With this flexibility, the EU could then tailor the type of credit support to governments (direct loans, provision of guarantees or bond buying), and the strings attached, for example to whether a country faces problems in its labour market, banking sector or sovereign debt market. As a result, the EU would have a more coherent toolbox of viable fiscal and crisis instruments under one roof, with the former ESM as its eurozone compartment. The right time to embark on such a project is now, because the EU may need to bail out a government as interest rates rise, which could put enough pressure on some member-states to risk calling on the ESM.

Of course, the ESM's €410 billion might continue to go unused even during this tightening cycle. But that capacity could still be useful to the EU, even if governments decide not to complete the banking union with it. If the ESM's capital were added to the EU's balance sheet, it would make it far stronger, especially if it were made into an explicit guarantee fund that would secure all EU and eurozone financial instruments.

Ultimately, it would be best if the ESM became the banking union backstop and became an EU institution. That way, the resolution and deposit insurance backstop would themselves be backed by EU budget resources. If a very large crisis exhausted the former ESM's resources, they could be topped up by EU member-states collectively tapping capital markets, as was done to create NGEU. This would make the EU, its member-states and its banking system more stable.

Having the implicit borrowing capacity of the EU behind the ESM also helps resolve the long-standing issue with the ESM's firepower. The ESM has always been too small to deal with a sovereign debt crisis in a major economy, leaving the ECB on the hook. The ECB has always made clear that a country that makes egregious policy mistakes will need an austerity programme and structural reforms, with support from the other EU institutions. This is part of a normal but delicate dance between the fiscal authorities and the central bank, as also recently witnessed in the UK. But if the ESM were a more credible and deep-pocketed fund, the ECB would be less likely to have to intervene to keep spreads from rising.

In conclusion, leaving the ESM unreformed would be the path of least resistance for eurozone governments. But the ESM's capital could be put to more productive use. As it stands, most governments will do everything they can to avoid using it. With financial and fiscal risks on the rise, Europe should urgently turn the institution into something more useful.

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