The ESM: A (strong) character in search of an author

Discussion of Giammarioli and Marimon

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The ESM and EMU architecture

• Initially: Crisis lender without a policy role
  • Programmes negotiated by IMF-Commission-ECB
  • Lending decisions taken by Eurogroup

• But born to lead
  • Treaty-based
  • Well funded
  • Equipped with elaborate governance
  • Strong management

• Gradual development of mission
  • More facilities: liquidity provider
  • Larger role: SRF backstop
  • Build-up: economic expertise

• Not a steady state though. Question then: Where to?
Model 1: a European IMF

**Assets**
- ✓ Same type of governance
- ✓ Similar facilities (ESM facilities range actually broader)
- ✓ Similar DSA role

**In process**
- ➢ Monitoring and conditionality

**Issues**
- ✗ Relationship with the IMF (conditionality / terms of lending / seniority)
- ✗ Governance (QMV decisions)
- ✗ Macro surveillance (overlap with Commission): increasingly an issue with liquidity facilities
Model 2: an ESF to fill the gaps of the euro architecture

Euro area incomplete and will remain so
Potential ESM roles as substitute to missing elements of the euro architecture
• Insufficient risk-sharing >> a stabilisation fund
• No budget >> a fiscal capacity
• No LLR for sovereigns >> no-default contracts
• No common safe asset >> an issuer of e-bonds

A European Stability Fund (ESF) as a response to these requirements
ESF: The basic set-up

Capital markets

ESM bonds

Contracts with countries

Contingent loan

Contingent loan

Contingent loan
Details

✓ No conditionality (critique of extensive and ultimately ineffective conditionality)

But:

• Experience-rated contracts between ESF and individual countries (no permanent transfers)
• Net transfer is state-contingent (provides stabilisation)
• Net transfer depends on performance (ex post conditionality)
• Net transfer adjusted to ensure enforcement constraints are respected (hence no default / no exit)
Concretely

Countries issue perpetual bonds whose coupon is:
- Indexed on GDP growth
- Dependent on past performance (high-growth/low volatility countries pay less)
- Adjustable depending on observed ex-post performance

ESF buys these bonds and issues joint plain vanilla e-bonds without mutualisation

Contract ensures:
- Sustainability (cos growth indexation)
- Participation (cos growth indexation)
- No permanent transfer (cos pricing)
Questions

How safe are ESF bonds?
• A fiscal authority's ultimate solvency hinges on its ability to raise taxes
• ESF revenues: highly procyclical (by design), no tax backstop
• Forward-looking enforcement constraints prevent raising levy on countries in response to past shocks
• Problematic if shocks correlated across countries
• ESF capital is the ultimate shock absorber

How much aggregate stabilisation?
• Solvency / stabilisation trade-off

Should IMF-style conditionality be abandoned?
• Important design issue
• Rationale for conditionality: correct policy errors
• Model assumes non-political governments
Addendum: Dealing with debt overhangs

• If euro area were to move to ESF-type contracts, why exclude prior debt restructurings?
Conclusion

ESM has been the perfect Swiss knife
Time to define the end-model

• European IMF: risk of irrelevance in benign rate environment
• Filling the gaps: risk of overreach