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

Discussion of Giammarioli and Marimon

CEPR/RPN and ESM conference, Luxembourg, 18-19 November 2019

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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

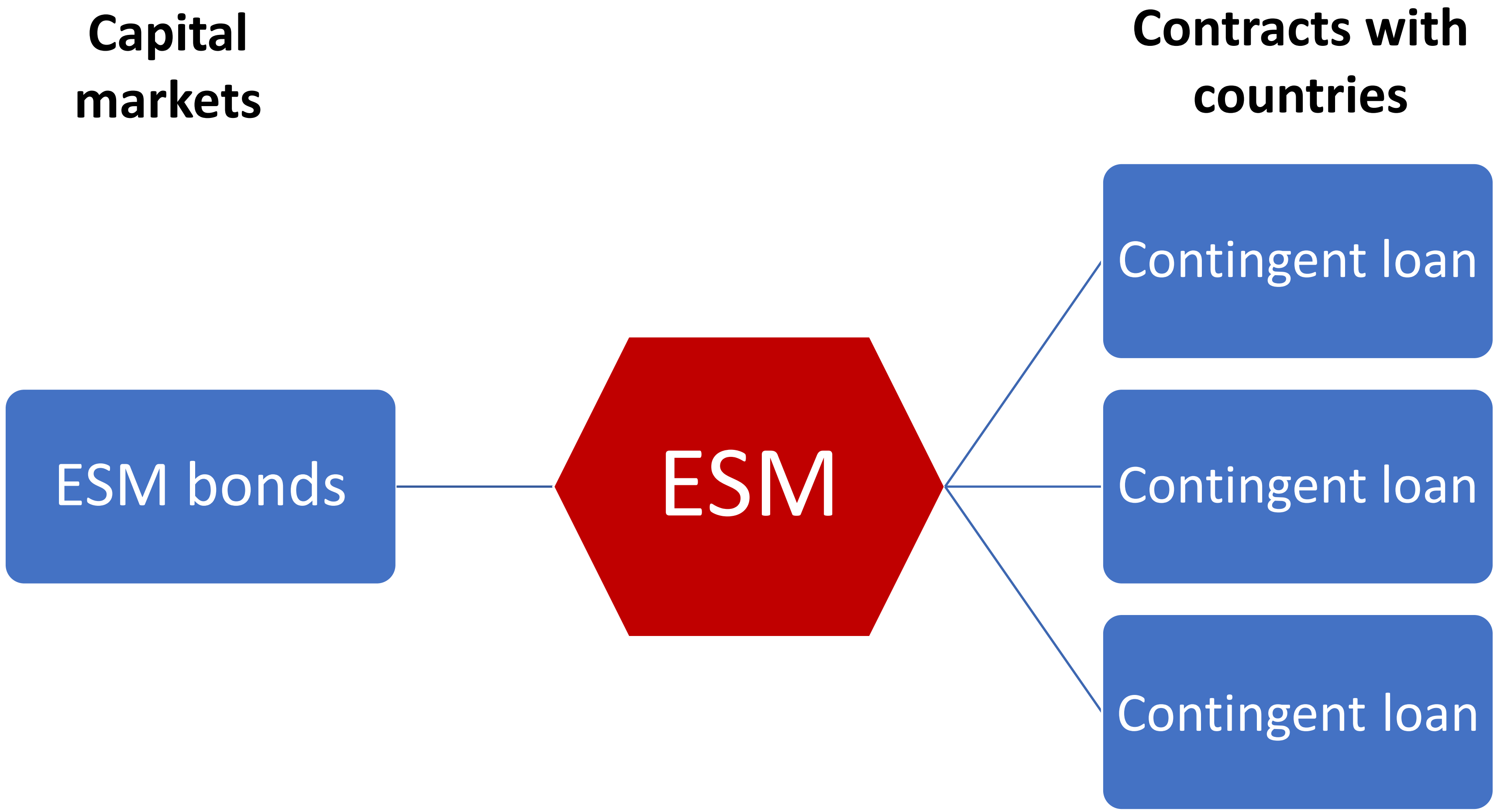
Euro area incomplete and will remain so

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



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