The time is right for a European Monetary Fund

The third banking union pillar, the common European deposit insurance, is still missing. André Sapir and Dirk Schoenmaker propose to design the EMF as part of a broader risk-sharing and market-discipline agenda

The issue

The creation of the European Stability Mechanism (ESM) and the banking union were instrumental in stemming the euro area sovereign crisis. However, both remain incomplete. While the ESM reduces the risk of sovereign debt crises, it still lacks an instrument to deal in an orderly way with insolvency crises. This makes the no-bailout clause of the Maastricht Treaty toothless. Two of the banking union's pillars – common European supervision by the European Central Bank and common European resolution by the Single Resolution Fund – are up and running. But the third, common European deposit insurance, is still missing. Furthermore, the governance of the ESM is wanting. Decisions to provide financial assistance are taken by unanimity, preventing swift crisis response when it is needed.

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Policy challenge

The re-election of Chancellor Merkel and the election of President Macron create a new momentum for strengthening the euro area's crisis framework. There is agreement to turn the ESM into a European Monetary Fund (EMF). We propose to design this EMF as part of a broader risk-sharing and market-discipline agenda. Risk sharing would come from the increased capacity of the EMF to intervene early in a sovereign or banking crisis and to act as a fiscal backstop to a complete banking union that includes European deposit insurance. Market discipline of sovereigns would come from the reduced exposure of banks to their home sovereigns and from a newly-established debt restructuring mechanism. The proposed transformation of the ESM into an EMF should be viewed as part of a wider institutional reform of the fiscal dimension of the euro area.

Introduction

Sovereign debt crises and banking crises were not supposed to happen in the euro area. Or more precisely, the Maastricht Treaty, which established the Economic and Monetary Union (EMU), contained no common provision to deal with a sovereign or banking crisis. The euro area was therefore totally unprepared when it was hit first in 2008 by a banking crisis, then in 2010 by a sovereign debt crisis, and eventually by a sovereign-bank 'doom loop' in which

the vulnerability of sovereigns and banks was mutually reinforced. This vulnerability seriously threatened the survival of the euro area.

The turning point came in 2012 with the creation of the European Stability Mechanism (ESM) and the first step towards a European banking union. These two political decisions effectively gave the space to Mario Draghi, president

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In practice, the EMF should take over the existing responsibilities from the ESM, but expand them and adopt a different governance model. The expansion of the EMF compared to the ESM should address the two channels of the sovereign-bank nexus: sovereign crises and banking crises

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of the European Central Bank (ECB), to declare in July 2012 that: *"Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."* Markets believed him and the sovereign-bank 'doom loop' gradually dissipated.

Today, thanks to the decisions taken in 2012, the euro area is in a much better state than it was five years ago. But it remains vulnerable to future sovereign debt and banking crises because the ESM's operations remain severely constrained and the banking union is still incomplete. Creating a better framework for managing crises should be the number one priority for euro area leaders.

Both French president Emmanuel Macron and German chancellor Angela Merkel agree that the ESM should be turned into a European Monetary Fund (EMF), but they seem to disagree on what its purpose should be[1]. Chancellor Merkel seems attracted by the idea that the EMF should be used to strictly enforce the fiscal rules, while President Macron appears to favour using the EMF as a euro area stabilisation mechanism. While both ideas have merits, we argue in this Policy Brief that the EMF should concentrate, at least for the moment, on managing sovereign debt and banking crises, which still constitute the greatest potential threat to the euro area's integrity.

EMU 1.0, EMU 2.0 and remaining weaknesses

Under the Maastricht rules, or EMU 1.0, each member country was supposed to take care of its own sovereign debt or banking problems. The Stability and Growth Pact (SGP), the only common instrument that existed besides the ECB, was for the surveillance (and correction) of public deficits by the European Commission. There was no common instrument in case a sovereign faced a liquidity or solvency crunch. For banks, there was not even a common instrument for the surveillance of risk, and there was no common instrument in case of a liquidity or solvency crisis. Everything was left in the hands of individual countries. The two columns headed EMU 1.0 in Table 1 describe this architecture.

The situation changed radically after the euro area was hit by a series of banking and sovereign crises. National and European authorities were forced to acknowledge that a sovereign or banking crisis, let alone a sovereign-cum-banking crisis, has implications for the entire area – even if it occurs in only one euro area country. As a result, they gradually took steps to create new common tools for the surveillance of sovereigns and banks, for the management of sovereign debt and banking crises, and for the resolution of banking crises.

EMU 2.0: the ESM, the banking union and the OMT

Four major steps were taken after the start of the crisis:

The first was the reinforcement of the surveillance of public deficits and debts by the European Commission, with the two-pack and six-pack measures, and the Fiscal Compact of the intergovernmental Treaty on Stability, Coordination and Governance[2].

The second step was the creation of the ESM, an intergovernmental instrument to provide financial assistance to euro area countries with temporary financial problems. Membership of the ESM is restricted to countries that are part of the Fiscal Compact. Its current members are all the euro area countries. The ESM offers three main facilities: lending to governments subject to a macro-economic adjustment programme (ex-post conditionality); precautionary financial assistance consisting of credit-lines available to countries that meet certain conditions (ex-ante conditionality); and lending for bank recapitalisation.

The third step was the decision to create a European banking union to strengthen financial stability in the euro area. The banking union architecture will consist of three separate mechanisms: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the European Deposit Insurance Scheme (EDIS). So far, only the first two mechanisms have been set up. Membership of the banking union is open to

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all EU countries, but only euro area countries are members currently. After the creation of the Single Resolution Board (SRB) and its Single Resolution Fund (SRF), the ESM decided to extend its bank recapitalisation instrument, initially only available to governments, to banks under strict conditions (see section 2.2).

The fourth step was the decision by the ECB to create the Outright Monetary Transactions (OMT) facility. The OMT programme allows the ECB to purchase government bonds on the secondary market subject to *ex-post* or *ex-ante* conditionality in the form of an ESM macro-economic adjustment programme or a precautionary credit line.

The current architecture, resulting from these four successive steps taken during the crisis, is described in the two columns entitled EMU 2.0 in Table 1.

Why the ESM needs to be improved

Although vastly superior to EMU 1.0, EMU 2.0 still suffers from three main weaknesses:

Treatment of sovereign debt: the new system reduces the risk of sovereign debt crises, partly thanks to the improved surveillance framework, and to a great extent thanks to the ESM's lending capability (€500 billion) and the ECB's OMT facility, which is potentially unlimited. With the ESM and the OMT, the new system is well equipped to deal with liquidity crises. However, it still lacks an instrument to deal in an orderly way with insolvency crises. That is a major weakness because it implies that the Maastricht Treaty's no bail-out clause would remain toothless. Bailing out a country facing a liquidity problem is perfectly justified on economic grounds, but bailing out a country facing an insolvency problem must be credibly prohibited.

Incompleteness of the banking union: the SSM is fully up and running, and is functioning well, at least for significant banks (Schoenmaker and Véron, 2016). The SRB is also up and running, but the SRF is still in tran-

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Table 1. EMU governance: from Maastricht (EMU 1.0) to the EMF (EMU 3.0)

Function	Sovereign debt			Banks		
(Institution in charge)	**EMU 1.0**	**EMU 2.0**	**EMU 3.0**	**EMU 1.0**	**EMU 2.0**	**EMU 3.0**
Surveillance	SGP	Two-pack, six-pack, Fiscal Compact	Two-pack, six-pack, Fiscal Compact	Supervision	Supervision	Supervision
(Institution in charge)	(European Commission)	(European Commission)	(European Commission)	(national)	(SSM-ECB)	(SSM-ECB)
Crisis management	-	Euro area loan & OMT	Euro area loan & OMT	Lender of last resort	Lender of last resort	Lender of last resort
(Institution in charge)	-	(ESM & ECB)	(EMF & ECB)	(national ELA)	(national ELA)	(ECB ELA)
Crisis resolution	-	-	SDRM	Resolution & deposit insurance	Resolution & deposit insurance	Resolution & deposit insurance
(Institution in charge)	-	-	(EMF)	(national)	(SRB & national)	(SRDIB with EMF)

Source: Bruegel. Note: ECB = European Central Bank; ELA = emergency liquidity assistance; EMF = European Monetary Fund; SDRM = Sovereign Debt Restructuring Mechanism; SGP = Stability and Growth Pact; SSM = Single Supervisory Mechanism; SRB = Single Resolution Board; SRDIB = Single Resolution and Deposit Insurance Board.

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sition. In addition, use of the ESM's direct recapitalisation instrument is subject to such strict conditions that it falls short of a credible ex-ante fiscal backstop to the SRF. Finally, there is still no agreement among governments to set up a European deposit insurance mechanism.

Governance of the ESM: unlike the International Monetary Fund (IMF), where decisions to provide financial assistance to a member country are taken by a majority vote, ESM decisions require unanimity and the prior approval of some national parliaments. The unanimity rule also applies for lending under the direct recapitalisation instrument. Consequently, in practice, ESM resources are only granted as a final resort. Earlier intervention, before a country loses market access and provided it meets certain conditions, could mitigate or even prevent full-blown crises, thereby saving money and jobs. The same logic applies to the direct recapitalisation instrument for banks.

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Transforming the European stability mechanism into a European monetary fund

The weaknesses of EMU 2.0 can be corrected by turning the European Stability Mechanism into a European Monetary Fund. The EMF should be fully capable of acting as the fiscal counterpart of the ECB to guarantee the financial stability of the euro area in the event of a sovereign or banking crisis, or a threat of a crisis. This risk sharing function of the EMF must go hand-in-hand with the reduction of the risk of sovereign and banking crises. The creation of the SSM, which reduces the risk of banking crises, was an important step forward. Giving the EMF the responsibility for dealing with insolvent sovereigns would be equally important to reduce the risk of sovereign crises. Finally, introducing concentration charges or limits on the sovereign exposure of banks would reduce the risk of sovereign-bank 'doom loops'.

Turning the ESM into an EMF would solve major governance questions. It is important to integrate the governance of sovereign and bank crises within both the ECB and the EMF. The rationale for this is that ultimately the standing

of a banking system depends on the strength of the fiscal authority behind it and on its ability to provide a fiscal backstop (Schoenmaker, 2017). A banking crisis can turn into sovereign crisis when the sovereign cannot offer a credible backstop to its banking system. In the euro area, the ECB can or should be able to prevent or to manage a sovereign or a banking crisis as long as it is a matter of providing liquidity on a temporary basis. Beyond that, it should be the responsibility of the EMF, as the fiscal agent of euro area governments, to protect the stability of governments and banks.

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In practice, the EMF should take over the existing responsibilities from the ESM, but expand them and adopt a different governance model. The expansion of the EMF compared to the ESM should address the two channels of the sovereign-bank nexus: sovereign crises and banking crises.

The EMF and sovereign crises

In terms of the governance of sovereign debt crises, some, such as Germany's former finance minister Wolfgang Schäuble, have argued that the EMF should take over from the European Commission the responsibility for surveillance of the adherence to the fiscal rules (Schäuble, 2017). According to this view, the European Commission is too political and not sufficiently independent from the countries it is meant to watch over to enforce the rules with sufficient rigour.

However, it is doubtful that the EMF will be less political and more independent from its member countries than the European Commission. The ESM is certainly not. In fact, it is unlikely that any official European body – the Commission, the ESM or the EMF – could have the power (bestowed upon it by the member states) to strictly enforce the EU fiscal rules and completely avoid debt sustainability problems.

A more promising approach would be to give teeth to the no bail-out clause of the European treaty by setting up a European Sovereign Debt Restructuring Mechanism to ensure orderly resolution in the euro area (see Gianviti *et al*

(2010) for an early proposal). The creation of this mechanism would strengthen market discipline and help prevent future sovereign debt crises.

The European Sovereign Debt Restructuring Mechanism would have both an adjudication function and a financial function. It would be able to initiate and conduct negotiations between an insolvent sovereign debtor and its creditors, resulting in an agreement on how to reduce the present value of the debtor's future obligations in order to re-establish the sustainability of its public finances. A special court would make the settlement between the debtor and creditors binding on all parties, provided it has been approved by a qualified majority of all creditors. The court would work in close partnership with the EMF, which would assess when a sovereign debtor has become insolvent, by how much its debt should be reduced, and what its future primary surplus should be to restore its debt sustainability. The EMF would also have the task of providing financial assistance to the debtor country to help it undertake the necessary economic adjustment towards fiscal sustainability. Such assistance should only be provided after an agreement between the debtor and the creditors re-establishing solvency has been reached.

We do not recommend that all EMF financial assistance should be conditional on debt restructuring. Rather we envisage that, like the ESM, the EMF would continue to lend money to solvent sovereigns that face temporary difficulties. Only in exceptional situations, when the EMF would have judged a sovereign to be insolvent and when the insolvency procedure by the arbitration arm of the European Sovereign Debt Restructuring Mechanism has led to an agreement between the sovereign debtor and its creditors, should lending by the EMF be conditional on debt restructuring.

The creation of the European Sovereign Debt Restructuring Mechanism and the possibility of sovereign debt restructuring should be accompanied by significant changes in the regulatory treatment of banks' sovereign exposures. As argued elsewhere (ESRB, 2015), this could take the form of risk weights or concentration limits on sover-

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eign bonds held by banks[3]. Such changes would further strengthen market discipline and limit the risk of future sovereign debt crises (and the related redenomination risk).

The EMF and banking crises

The second area in which the new EMF should have an expanded remit compared to the current ESM is the governance of banking crises. Here the guiding principle should be to align incentives and responsibilities at the appropriate decision-making levels. Now that the ECB supervises significant banks directly and less significant banks indirectly[4], it should also be responsible for Emergency Liquidity Assistance (ELA) to banks experiencing liquidity problems, a function currently carried by national central banks (Goodhart and Schoenmaker, 2014).

The same guiding principle should apply to crisis resolution. The SRB is already in charge of resolution in the euro area and manages the SRF, which is still in a transition phase. A European Deposit Insurance Scheme should also be created and managed by the same institution that manages resolution, similarly to the Federal Deposit and Insurance Corporation in the United States. This new integrated EU body, which could be called the Single Resolution and Deposit Insurance Board, could apply the least cost principle, which requires the resolution authority to choose the resolution method with the least cost to the resolution and deposit insurance fund in terms of the total amount of expenditures and (contingent) liabilities incurred. The combination of functions would allow for swift decision-making (Gros and Schoenmaker, 2014).

The role of the EMF would be to serve as a fiscal backstop to the euro area banking system. This would mean three things. First, the procedure for the implementation of the direct recapitalisation instrument should be simplified so it can actually be deployed when needed. Second, the EMF should be allowed (alone or with member states) to participate in precautionary recapitalisations. Third, the EMF should be able to provide a credit line to the Single Resolution and Deposit Insurance Fund, the new integrated fund in which the Single Resolution Fund and the European

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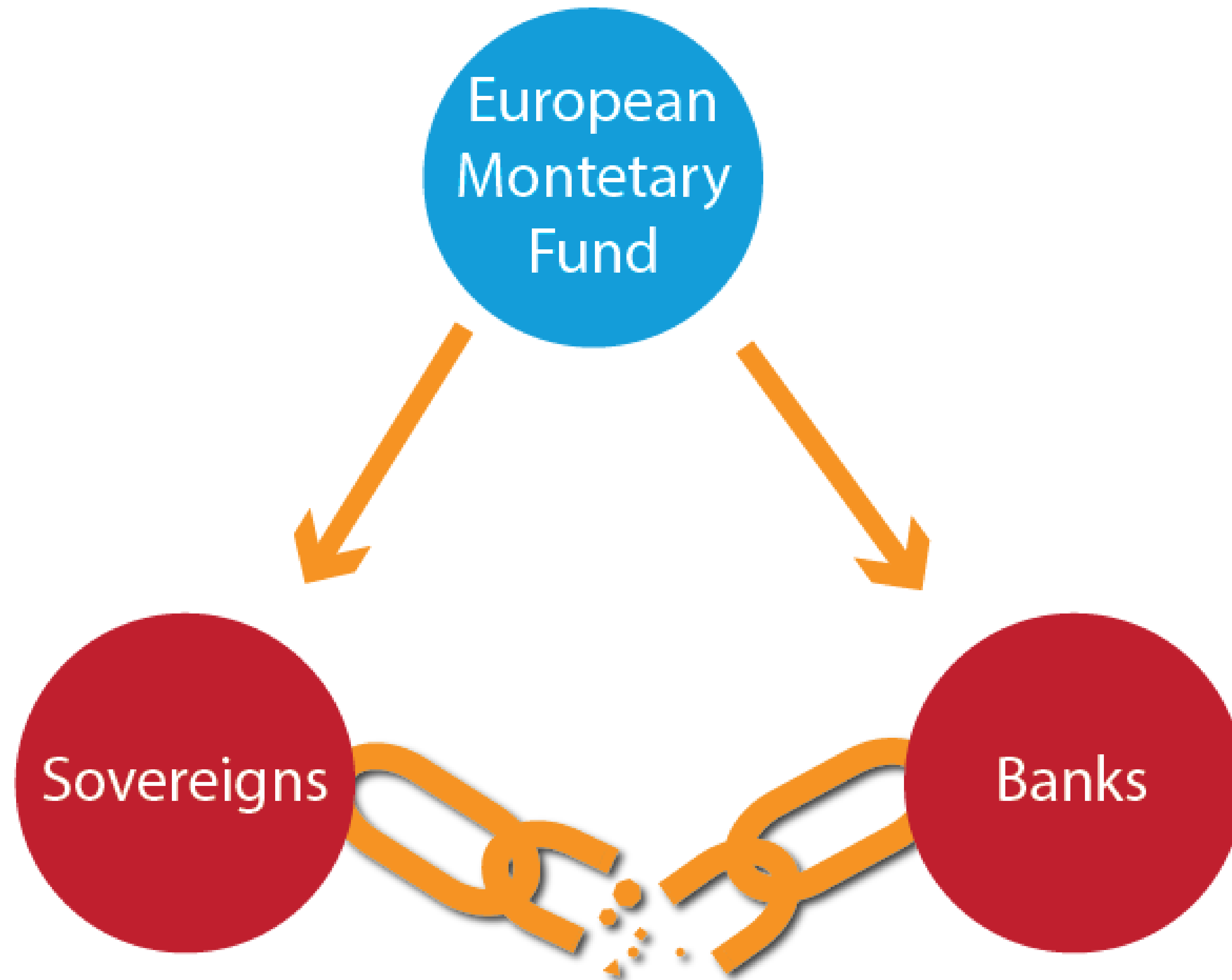
A new European Monetary Fund breaking the sovereign-bank link



Source: Bruegel

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Deposit Insurance Fund would be combined, managed by the Single Resolution and Deposit Insurance Board, just as the US Treasury can provide, and has provided, to the Federal Deposit and Insurance Corporation.

It is important to note that the risk of moral hazard associated with the EMF acting as a fiscal backstop to the banking system would be much reduced if (i) the regulatory treatment of sovereign exposures by banks was tightened in conjunction with the creation of the European Sovereign Debt Restructuring Mechanism, which effectively reduces redenomination risk, as proposed above; (ii) the non-performing loans were reduced and provisioning for them was increased as recently proposed by the ECB[5]; and (iii) deposit insurance premiums were risk based, as recently proposed by the European Commission[6].

The logic of our proposal is that the EMF should not deal only with sovereign crises or only with banking crises. It should deal with both in order to effectively prevent the reoccurrence of sovereign-bank 'doom loops'.

The proposed architecture of the new regime is described in the two columns entitled EMU 3.0 in Table 1.

The governance of the EMF

The new role assigned to the EMF would require a new form of governance compared to the ESM. The most important change would be to abolish the unanimity rule that hampers ESM decisions. All EMF financial-support decisions, whether they involve governments, banks or the Single Resolution and Deposit Insurance Board, should be taken by a supermajority[7]. Beyond that, there is the question as to whether the EMF should be intergovernmental like the ESM and the IMF, or a European institution like the European Investment Bank (EIB) or the ECB. Note, however, that the question of unanimity versus supermajority voting is separate from the question of intergovernmental versus European institutions. Unanimity is not required in the intergovernmental IMF or in the EU-treaty based ECB and EIB.

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Establishing the EMF as an EU institution would give it greater European legitimacy. In the ESM, all the important decisions are taken by the Board of Governors, which is made up of the finance ministers of the Eurogroup. In the EMF, the Board of Governors could comprise the Eurogroup ministers and also a euro area 'finance minister' and a few other representatives of the euro area, which would together constitute a 'Eurosystem of Fiscal Policy' (Sapir and Wolff, 2015).

The Eurosystem of Fiscal Policy would be a Community institution replacing the informal Eurogroup as the body responsible for all the fiscal decisions in the euro area and would also become the political counterpart of the independent ECB. The euro area 'finance minister' and the other euro area representatives would be appointed by the European Council subject to approval by the European Parliament, to which they would be accountable.

Conclusions

President Macron and Chancellor Merkel agree that the ESM should be turned into an EMF, but they seem to disagree on what its purpose should be. In a nutshell, Macron sees the EMF as an instrument for risk sharing, while Merkel sees it as a tool for risk reduction.

The president of the European Commission, Jean-Claude Juncker, has often indicated, with reference to the banking union, that *"it can only function if risk-reduction and risk-sharing go hand in hand"* (Juncker, 2017).

Meanwhile, a group of 15 French and German economists (see Bénassy-Quéré *et al*, 2017) proposed a set of reforms for the euro area that also combines elements of market discipline and risk sharing. We share their view that Germany needs to accept the idea of greater risk sharing in the euro area, while France needs to accept the idea of a greater level of market discipline[8].

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Our proposal to transform the European Stability Mechanism into a European Monetary Fund seeks to achieve a balance between market discipline and risk sharing. The latter would come from the increased capacity of the EMF to intervene early in a sovereign or banking crisis, rather than to act only as a last resort, as is the case for the ESM, and from the EMF's capacity to act as a fiscal backstop to a complete banking union that includes a European deposit insurance mechanism. Market discipline of sovereigns would come from the reduced exposure of banks to their home sovereigns and from the feasibility of using the EMF to restructure sovereign debts without a banking panic.

The transformation of the ESM into an EMF should not be viewed as a stand-alone initiative. It should be considered as part of a wider institutional reform of the fiscal organisation of the euro area, which should be aimed at better managing sovereign and debt crises, and at improving economic conditions in less severe situations. ■

André Sapir and Dirk Schoenmaker are Senior Fellows at Bruegel

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1. See, for instance, Münchau (2017).
2 The 2011 six-pack EU legislation, the 2012 Fiscal Compact and the 2013 two-pack EU legislation aimed to reinforce the monitoring and surveillance of economic policies and to improve the enforcement of EU fiscal rules in euro area countries.
3. Véron (2017) favours sovereign concentration charges or limits because these address the home bias problem and thus reduce the concentration risk. Moreover, concentration limits would not put euro area banks at a disadvantage com-

pared to other banks.

4. The ECB is sole decision-maker on the granting or removal of all banking licenses in the banking union area, and for related decisions such as the vetting of changes in bank ownership and of newly appointed bank executives as 'fit and proper'. This is also true for the 3,520 smaller banks that are considered 'less significant' meaning they fall below the threshold of €30 billion in total assets. For these banks, day-to-day supervisory tasks are left to the national supervisor, but the ECB retains ultimate decision-making authority. In this capacity, the ECB can wield all the tools that are given to national supervisors by EU banking legislation (Véron, 2015).

5. See https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr171004.en.html

6. See https://ec.europa.eu/info/publications/commission-proposal-european-deposit-insurance-scheme-edis_en

7. There has been discussion as to whether this change would be compatible with the German legal order. The judgements of the German Federal Institution Court in Karlsruhe of 12 September 2012 (http://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2012/09/rs20120912_2bvr139012en.html) and of 18 March 2014 (https://www.bundesverfassungsgericht.de/Shared-Docs/Pressemitteilungen/EN/2014/bvg14-023.html) require Bundestag involvement for financial assistance decisions. That would remain possible as long as Germany was to retain a blocking vote (veto power), which could be the case with supermajority voting. But this would not fundamentally change the last-resort logic of the ESM. The only solution to solve this problem is to restrict the requirement to obtain prior approval from the Bundestag (or any other national parliament) to a capital increase of the EMF. As the liability of each EMF member would be limited to its portion of the EMF's capital (as is the case with the ESM), we do not see a reason for separate approval by national parliaments of individual financial assistance decisions.

8. They note that "Germany needs to accept the idea of more risk sharing in the euro area – but should insist that this is done in a way that maintains sound incentives, does not become a vehicle of permanent redistribution and increases the credibility of the no-bailout rule for sovereigns and of the bail-in framework for banks… [and] France needs to accept the idea of more market discipline – but should insist that this is introduced in a way that does not lead to financial instabili-

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ty" (Bénassy-Quéré et al, 2017).

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