

Economic Intelligence

Up-to-the-Minute Analysis from
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European Stability Mechanism: Missing in Action? Why and How the ESM Needs to Be Mobilised A Three-Step Programme

Now that the European Central Bank (ECB) has launched its own significant bazooka – the €750 billion pandemic emergency purchase programme - policymakers must turn their attention to the one institution still to deliver: the European Stability Mechanism (ESM).¹ Since 2012, when the ESM was set up, the prevailing mantra has been that Europe is well-prepared for the next crisis.² There is no doubt that the eurozone is much better equipped than in 2010, when no funds, mechanisms or crisis-fighting institutions were at hand, and this is of course positive. But it is then all the more stunning that well into the Covid-19 crisis, **the ESM's unused lending capacity – a remarkable €410 billion (3.4% of euro area gross domestic product) – sits idle in Luxembourg.**

So far, the ESM is a mere bystander in circumstances where no institution in that position may be considered “innocent.” The only initiative to date is a brief eurogroup resolution that the ESM “explore ways... to address the challenges posed by the coronavirus.”³

¹ **Economic Intelligence** is a series of up-to-the-minute policy briefs from Alessandro Leipold, chief economist of the Lisbon Council and former acting director of the International Monetary Fund's European Department and later executive director for Italy, Greece, Portugal, Malta, Albania and San Marino. Special thanks to Paul Hofheinz, Chrysoula Mitta, David Osimo and Viorica Spac.

² ESM Managing Director Klaus Regling said in 2019: “Can the euro area weather the next crisis? Luckily, this question does not keep me awake anymore at night... To make best use of your time I could just simply answer with a ‘yes.’” See Klaus Regling, “Can the Euro Area Weather the Next Crisis?” *European Stability Mechanism*, 11 April 2019.

<https://www.esm.europa.eu/speeches-and-presentations/can-euro-area-weather-next-crisis-speech-klaus-regling>

³ Mário Centeno, “Remarks following the Eurogroup Meeting of 16 March 2020,” *European Council*, 16 March 2020.

The request came on Monday, 16 March 2020. And, as of Thursday, 19 March, nothing has yet emerged. We propose three steps to urgently deploy the full firepower of the ESM, rapidly and effectively, and, in that way, to also unlock the clout of the ECB's outright monetary transactions (OMTs).

Three Steps to Unleash ESM Firepower

1. **Provide** ESM lending free of conditionality, either through existing precautionary lines or a new window (similar to the IMF's rapid financing instrument).
2. **Agree** with the ECB that such lending would unlock its outright monetary transactions for recipient states.
3. **Extend** such lending with multiple lines to all member states undertaking Covid-19 action, avoiding possible stigma.

Let us first dispense some of the objections raised by the more "rigorous" euro area members.⁴ There are, for example, concerns that "attempting to bring the ESM into play soon could send the wrong signal and further sap investor confidence." Similarly, it is feared that "involving the ESM too early on could backfire, sending a message to investors that the euro area is in bad shape and drawing attention to a tool that may be needed later."⁵ German Finance Minister Olaf Scholz has maintained that "the debate on whether we have to deploy the ESM is premature. The existence of the ESM alone provides stability because it can be used at any time and has an enormous firepower."⁶

For his part, ESM Managing Director Klaus Regling has stressed the very different circumstances compared to 2010-12, noting the positives: i.e., that all member states presently have market access and that all face "very low, historically low interest rates."⁷

<https://www.consilium.europa.eu/en/press/press-releases/2020/03/16/remarks-by-mario-centeno-following-the-eurogroup-meeting-of-16-march-2020/>

Incidentally, it is odd that the eurogroup ask the ESM to examine how it could help in the current crisis, when the eurogroup and the ESM board of governors are made up of the very same people – a reflection of an original sin: the ESM's intergovernmental governance structure.

⁴ See Sam Fleming, Jim Brundsen and Martin Arnold, "EU Debates Whether to Harness Crisis Fund in Coronavirus Battle," *Financial Times*, 18 March 2020.

<https://www.ft.com/content/d6f5a4ba-6870-11ea-800d-da70cff6e4d3>

⁵ Ibid.

⁶ See Martin Greive and Jan Hildebrand, "Olaf Scholz: "Wir Werden die Wirtschaft Nicht Hängen Lassen," *Handelsblatt*, 16 March 2020.

<https://www.handelsblatt.com/politik/deutschland/finanzminister-zu-corona-hilfen-olaf-scholz-wir-werden-die-wirtschaft-nicht-haengen-lassen/25648762.html?ticket=ST-261558-4N0rPjorJZnExfIRMdKH-ap3>

⁷ Klaus Regling, "Transcript of remarks by ESM Managing Director," 16 March 2020.

<https://www.esm.europa.eu/press-releases/klaus-regling-eurogroup-video-press-conference>

Nonetheless, he noted, “we will think... *whether and how* (our emphasis) the ESM facilities could be useful under current circumstances.”⁸

“Premature”? “Whether and how”? One can in truth only counter with a dyed-in-the-wool retort: “If not now, when?” The rest of this Economic Intelligence will not address the “whether” but will focus on the “how,” given the evident need for immediate and decisive action.

Fire at Will

The first step is to **provide ESM lending free of conditionality**. The ESM has long been stymied by an original sin in its creation, i.e., the wording of the provision setting it up without recourse to a new European Union treaty. This legal *escamotage* took the form of the addition of a paragraph to Article 136 of the treaty which *inter alia* stipulated that “the granting of any required financial assistance... will be made subject to strict conditionality.”⁹ This requirement was not in itself problematic as long as the only facility in the ESM’s toolkit was that of traditional macroeconomic adjustment lending. Once the arsenal was extended in 2011 to include precautionary lending, there arose a tension, which remains largely unresolved.¹⁰ While the revision to the ESM treaty, agreed in principle by the eurogroup on 04 December 2019, included amended guidelines on precautionary financial assistance directed at enhancing the facilities’ effectiveness, there remains an excessive rigidity, both in the details of the facilities and in the decision-making process.

At this point, **the ESM board of governors should state that ESM precautionary lending will be free of conditionality and of the need for a standard memorandum of understanding (MOU) for the duration of the Covid-19 emergency.**¹¹ We appreciate that there are legal obstacles to such a step, but the current cataclysm (as it should be seen) is such as to sharpen the minds of legal eagles and forge the political will. The draft revised ESM treaty currently on the table does provide that the board of governors may decide, by mutual agreement, “to change the eligibility criteria for precautionary financial assistance.”¹² This should be done forthwith.

⁸ Ibid.

⁹ European Council, *Decision of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with Regard to a Stability Mechanism for Member States Whose Currency is the Euro* (Decision 2011/199/EU).

<https://op.europa.eu/en/publication-detail/-/publication/1ca9c267-4b55-4123-b51f-c0ad616b2956/language-en>

¹⁰ For a detailed discussion of this issue, see Alessandro Leibold, “Lessons from Three Years of Euro Area Crisis Fighting: Getting it Right Next Time,” *The Lisbon Council*, 06 June 2013.

https://lisboncouncil.net/index.php?option=com_downloads&id=857

¹¹ The new guidelines do provide for a simple letter of intent, rather than a full-fledged memorandum of understanding in case of activation of the so-called precautionary conditioned credit line, as opposed to the more demanding enhanced conditions credit line. See ESM, *Draft Guideline on Precautionary Financing Assistance*.

<https://www.consilium.europa.eu/media/41672/20191206-draft-precautionary-guideline.pdf>

¹² European Council, “Draft Revised Text of the Treaty Establishing the European Stability Mechanism,” 14 June 2019, Article 5(6f) and Article 14(1).

<https://www.consilium.europa.eu/media/39772/revised-esm-treaty-2.pdf>

It would appear easier to apply this provision to the precautionary conditioned credit line than the more stringent enhanced conditions credit line. Alternatively, the ESM could introduce a facility analogous to the IMF's rapid financing instrument. This instrument is designed to disburse rapidly in cases of exogenous shocks requiring a quick response and where "a full-fledged economic programme is either not necessary nor feasible."¹³

Whatever instrument is chosen, it should meet the ECB's requirement for unlocking its outright monetary transactions (OMTs) – hence ESM-ECB agreement on this is the second step we advocate. The OMTs are the instrument whose only announcement, part and parcel of Mario Draghi's "whatever it takes," calmed markets and engineered a turnaround of the euro area crisis in mid-2012.¹⁴ They have not been deployed to date, at least in part because no member state has availed itself of the ESM's precautionary facilities, a precondition for access to OMTs. In any event, their use now would require modifying the 2012 position whereby "a necessary condition for outright monetary transactions is strict and effective conditionality attached to an appropriate... ESM programme."¹⁵

The highly welcome announcement, on 18 March 2020, of the ECB's new pandemic emergency purchase programme, amounting to €750 billion (on top of the €120 billion quantitative easing package), takes away some urgency from the need for OMTs and buys time.¹⁶ During such time, activation of OMTs could usefully be eased and streamlined. In the process, the ECB could also overcome its unwillingness, to date, to publish the legal texts governing outright monetary operations, reportedly intending to do so only when activation becomes imminent.¹⁷ This would help alleviate lingering uncertainty and doubts surrounding their actual deployment.¹⁸

Finally, **to address stigma concerns, ESM lending should be extended to all or at least a wide swathe of member states undertaking Covid-19 action**, with simultaneous multiple credit lines. As noted, the ESM's precautionary facilities have never been used. This

¹³ International Monetary Fund, "The IMF's Rapid Financing Instrument (RFI)," 12 March 2020. <https://www.imf.org/en/About/Factsheets/Sheets/2016/08/02/19/55/Rapid-Financing-Instrument>

¹⁴ OMTs are in essence a programme under which the ECB makes purchases in secondary sovereign bond markets under certain conditions. For details, see ECB, *Technical Features of Outright Monetary Transactions*, 06 September 2012.

https://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html
For an excellent overview of the OMT programme, see Benoît Cœuré, "Outright Monetary Transactions, One Year On," Conference on "The ECB and its OMT Programme," 02 September 2013. <https://www.ecb.europa.eu/press/key/date/2013/html/sp130902.en.html>

¹⁵ See European Central Bank, *Technical Features of Outright Monetary Transactions*, op. cit.

¹⁶ European Central Bank, "ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP)," 18 March 2020.

https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html

¹⁷ Eva Kuehnen, "ECB Only to Publish OMT Legal Act if Activation Imminent," *Business Insider*, 29 April 2013.

<https://uk.reuters.com/article/uk-ecb-omt/ecb-only-to-publish-omt-legal-act-if-activation-imminent-idUKBRE93S09120130429>

¹⁸ See, among many, Simon Wrey-Lewis, "Is OMT a Bluff?," *Mainly Macro*, 17 December 2015.

<https://mainlymacro.blogspot.com/2015/12/is-omt-bluff.html>

is partly due to their rigidity, but also due to the fear of stigma. Indeed, the IMF itself long struggled to devise a precautionary facility that would be used by all who needed a safety net. Extending lending broadly would address this reticence, not singling out any country, and sending an “all-in-the-same-boat” message of solidarity, at present sorely lacking.

There is no absence of occasions to move swiftly along the three steps advocated in this Economic Intelligence. The ESM should promptly respond to the eurogroup request of 16 March 2020 and the frequent video conferences at ministerial and European Council level can provide the opportunity to take the related decisions, untying the ESM’s hands. While everyone is confined to home, it is time for Europe’s political leaders to break out from their own constraining boundaries. Just do it.

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