An evolutionary path for a European Monetary Fund?

The ESM is currently the permanent crisis resolution mechanism for the Member States of the Euro Area. It provides financial assistance to Member States,which is granted under strict conditionality. The ESM has paid in capital, given by the Euro Area Member States, and borrows money on capital markets to provide loans to an ESM Member. A separate EGOV note gives an overview of the ESM main features.

In the current debate on the deepening of the Economic and Monetary Union, one of the topical issues is the future role of the ESM (e.g. the Reflection paper on the deepening of EMU, p. 28, and the Five Presidents Report, pp. 20-21, which called, *inter alia,* for the integration of the ESM in the EU law framework in the medium term).

In February 2017, the ECON Committee requested three external contributions on whether, and if so how, the competences of the ESM should be expanded in the direction of those recognised internationally to the IMF, for the ESM to become the European Monetary Fund (EFM).

Charles Wyplosz (*The Graduate Institute, Geneva*)

In his paper, Prof Wyplosz argues that the evolution of the ESM into the EMF is neither necessary nor desirable.

After analysing some historical experiences, he notes that the ultimate goal of an EMF (like of the IMF) should be to avoid debt crises, which requires achieving fiscal policy discipline and prevent financial sector's stress that may lead governments to borrow heavily. In the EU, the Stability and Growth Pact was established with this scope, but repeatedly failed. Nevertheless, the setup of an EMF would not make the Pact more effective, but on the contrary would make it weaker. The EMF would be an institution created to bail countries out, and by dismissing the no-bail out clause, it would create moral hazard. The IMF deals with moral hazard issues as well, but in a smaller measure, as closely-knit countries like the euro area ones would have large looming conflicts of interests.

Furthermore, the EMF would have surveillance and analytical tasks that are currently carried out by the Commission (fiscal and macro-economic aspects) and the Eurosystem (financial supervision). If these tasks were duplicated, then this would imply a waste of resources. If these tasks were transferred, then governance and accountability features would need to be dealt with.

In the end, the only reason to have a EMF when the world already has the IMF is that the IMF's resources are insufficient to deal with a major crisis that affects developed countries deeply integrated (especially financially, as the crisis would become contagious). A possible solution, already put in practice, is for the IMF to design and implement country programmes, and to collect fund from friendly - typically neighbours - countries.

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Daniel Gross (*CEPS*)

In his paper, Mr. Gross argues that the ESM already acts to a large extent as a 'European Monetary Fund' insofar it provides the backstop for sovereigns, even without a financial contribution from the IMF. However, he consideres that other tasks performed by the IMF, namely surveillance and policy coordination, should remain with the Commission, the Eurogroup and other existing bodies. He also points out that the existing differences between the ESM and the IMF (rationale for lending, decision-making, staffing and the role played by the staff in operations) are likely to persist as (1) the fiscal risks from ESM operations are an order of magnitude larger than those of IMF lending, and (2) ESM financing can represent a much larger share of the overall financing needs of a country than IMF credits.

Based on this assessment, the author advocates for two substantive changes to the ESM, namely: (1) no further IMF co-financing, as opposed to technical advice, should be solicited in future ESM programmes and (2) Euro Area Member States should pool their IMF quotas in the ESM, which would represent the entire euro area at the IMF. In addition, once the Single Resolution Fund (SRF) is fully established, the direct recapitalisation instrument of the ESM would no longer be needed (the ESM would instead provide a back-up directly to the SRF). Finally, the ESM should be brought into the Treaty in the long run.

To conclude, Gros argues that any evolution in the funcitoning of the ESM should aim at enhancing flexibility and clartiy of its overall mandate (financial stability), rather than revising the details of the rescue mechanism (which should be extended to the SRF) and its modus operandi. Moreover, the ESM could be seen as the nucleus of a euro area fiscal instrument for financial stability, which could later be used to bundle the euro area's contribution to global financial stability via the IMF. The balance between providing a back-up to national governments, or to common euro area institutions (such as the SRF or a future deposit insurance system) is likely to change over time and in ways that are difficult to anticipate.

Jonathan Rodden (*Stanford University*)

Prof. Rodden provides an overview of the mechanisms of inter-regional insurance and redistribution. In the United States, inter-regional fiscal stabilization is achieved through a progressive income tax. Contrary to common opinion, federal direct expenditures and grants are targeted neither to states suffering from short-term asymmetric negative shocks, nor to relatively poor states in the long term. Fiscal policies of state and local governments are highly pro-cyclical, and partially undermine the stabilizing role of the system of federal taxes and transfers. If Eurozone reformers look at the United States and other federations as they seek to craft a more sustainable architecture for the Euro, they should focus more on related issues of moral hazard and fiscal discipline. However, the U.S. experience suggests a number of design challenges facing any future Eurozone stabilization mechanism.

The paper also places proposals for even stronger top-down surveillance and correction mechanisms of Eurozone member states' fiscal policies in comparative perspective, arguing that such powers are not found in unions of sovereigns like the United States, Canada, and Switzerland. Moreover, there are reasons for concern about the credibility of such efforts in the Eurozone as currently structured.

According to Rodden, unless political will can be found for extraordinary political and fiscal centralization, reformers should assume that Member States will continue as sovereigns, and hence will be disciplined (or not) by voters and credit markets rather than European regulators. Thus it might be useful to consider policies that would make the "no-bail out clause" credible.

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