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IN-DEPTH ANALYSIS

An evolutionary path towards a European Monetary Fund

External author: **Daniel Gros**
Centre for European Policy Studies

Provided at the request of the
Economic and Monetary Affairs Committee

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Scrutiny paper provided in the context of Economic Dialogues with the President of the Eurogroup in the Economic and Monetary Affairs Committee

Abstract

There is no need for Europe to replicate the International Monetary Fund (IMF). The European Stability Mechanism (ESM) can provide the backstop for sovereigns, even without a financial contribution from the IMF. In this sense, the ESM already constitutes to a large extent a 'European Monetary Fund'. Other IMF functions such as surveillance and policy coordination should remain with the European Commission, the Eurogroup and other existing bodies. The ESM will be called upon to act as a backstop only intermittently, in times of great financial market instability. The need for it will evolve as a function of the nature of financial markets and their cross-border integration. It is not possible to forecast with any precision when the next financial crisis might break out and what form it will take. Any evolution in the functioning of the ESM should thus aim at enhancing flexibility and clarity of its overall mandate (financial stability), rather than revising the details of the rescue mechanism (which should be extended to the Single Resolution Fund) and its *modus operandi*. Moreover, the ESM should be viewed as the natural instrument for unifying the euro area's representation in the IMF.

This paper was requested by the European Parliament's Economic and Monetary Affairs Committee.

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LIST OF ABBREVIATIONS

BRRD	Bank Resolution and Recovery Directive
CMU	Capital Markets Union
DSA	Debt Sustainability Analysis
EMU	Economic and Monetary Union
EMF	European Monetary Fund
ESF	Single Resolution Fund
ESRB	European Systemic Risk Board
FDIC	Federal Deposit Insurance Corporation
IMF	International Monetary Fund
IIP	international investment position

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EXECUTIVE SUMMARY

The term European Monetary Fund (EMF) should be used with caution.

The International Monetary Fund (IMF) has two main functions:

- i) coordination/surveillance and
- ii) backstop for sovereigns, including program design.

The first function is performed in the euro area by a variety of institutions (European Commission, Eurogroup, etc.), and there is no need to change these arrangements. The second function is now performed by the European Stability Mechanism (ESM), at least in terms of providing the backstop for sovereigns, which raises the question of whether the ESM already acts as an EMF.

There are several differences between the ESM and the IMF in terms of philosophy (rationale for lending), decision-making, staffing and the role played by the staff in operations. These differences are likely to persist, mostly because the fiscal risks from ESM operations are an order of magnitude larger than those of IMF lending, and because ESM financing can represent a much larger share of the overall financing needs of a country than IMF credits. It is thus understandable that ESM programmes are of a much higher political importance than those of the IMF. Majority decisions on programmes will therefore remain necessarily more difficult in the case of the ESM. The same applies to the delegation of programme design to the staff level, which is the one function the ESM does not perform at present. But even with this constraint, there should be room for enlarging the professional staff of the ESM and to give it, at least de facto, greater autonomy to take some decisions on its own, particularly on programme design. Small, evolutionary steps in this direction could make the ESM equivalent to an EMF.

This is not to say, however, that there is no need to introduce more formal substantive changes. Two in particular are especially desirable:

- i) ESM programmes should be made independent of the IMF, and no further IMF co-financing (as opposed to technical advice) should be solicited in future ESM programmes.
- ii) Euro area member states should pool their IMF quotas in the ESM, which would represent the entire euro area at the IMF. The pooled IMF quota, about €60 billion, might then be placed at the disposal of euro area member states in difficulties with a 'lighter' decision-making procedure.

Once the Single Resolution Fund (SRF) is fully established, it would also be desirable to clarify that the direct recapitalisation instrument of the ESM would no longer be needed and that the ESM would then serve to provide a back-up to the SRF.

It would also be desirable to bringing the ESM into the Treaty framework in the long run, but this is not a priority compared to the two substantive changes.

Instead of concentrating on the minor changes needed to transform the ESM into a European Monetary Fund, it might be more constructive to view it 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.

1. INTRODUCTION

This paper was requested by the European Parliament under the supervision of its Economic Governance Support Unit.

When the constitution of the euro area, the Maastricht Treaty, was agreed, it appeared inconceivable that a member country could ever experience difficulties rolling over its debt, let alone not be able to service its debt in full. Moreover, just to forestall any doubts that public debt might become a common liability, the so-called bail-out clause was inserted.

Experience has shown, however, that even euro area member countries can sometimes lose market access. Insistence on the simple ‘no bail-out’ principle proved impossible when euro area financial markets seemed on the verge of a meltdown, which would have created enormous costs for the entire euro area economy given the large cross-border financial activity that had built up in the meantime. This is why, after some hesitation, the European Stability Mechanism (ESM) was created as a permanent ‘bail-out’ mechanism, to operate alongside the IMF, which alone could not provide the financing required to calm euro area financial markets.

The overall economic justification for both the IMF and the ESM is of course similar. It is grounded in the view that financial markets are not always efficient. This does not mean of course that financial markets never give the right signal, but experience has shown that, for a variety of reasons, financial markets sometimes become unwilling to provide financing at any cost (Stiglitz and Weiss, 1981). In the final analysis, it is not a question of economic theory, but one of experience; see the excellent recent summary in Weder di Mauro and Zettelmayer (2017).

The overwhelming majority of IMF programmes have succeeded in the end. As far as the ESM is concerned, one can only say that the same holds for four of its five programmes (counting also Spain). Only in one of these five cases, namely Greece, has success so far been elusive. This illustrates the general philosophy underlying official rescue operations: neither financial markets, nor politicians are always right. But financial markets panic with sufficient frequency to justify (ex post) most rescue operations. The relatively high success rate of IMF programmes is also due to the existence of a large professional and experienced staff, which can not only design adjustment programmes, but also provide a realistic view of their probability of success.

Having established the rationale for a lender of last resort or back-up for sovereigns, the next question is how this function should be fulfilled. At the global level the IMF provides a model that seems to have worked well for decades. When the euro crisis broke in 2009-10 it was thus natural that the idea of creating a ‘European Monetary Fund’ came about.¹ At that time, the euro area seemed to lack not only a financing mechanism for sovereigns in difficulty, but also an institution with the professional capacity to design and monitor assistance programmes as well as perform an independent analysis of the sustainability of (public) debt (Debt Sustainability Analysis, DSA).

The euro area now has the ESM, which can fulfil the back-stop function of the IMF. Nevertheless, it is often argued that the ESM should somehow be ‘transformed’ into a European Monetary Fund, implying that it does not really perform those functions at the present time. But it is often not clear

¹ The German Finance Minister Wolfgang Schäuble made a first proposal in 2010 <http://www.spiegel.de/international/europe/greek-debt-crisis-proposal-for-european-monetary-fund-wins-eu-support-a-682296.html>. Mayer (2009) was the first contribution in this direction. Gros and Mayer (2010a and b) published a first concrete outline, which was subsequently elaborated and extended in a number of other publications (Gros and Mayer, 2011a and b and 2012). The discussion has usually concentrated on the particular ‘need of the moment’, as Annex 1 shows with the reaction to Gros and Mayer (2010).

what would be needed to transform the ESM into an EMF (taking into account that the EMF would operate within one currency area whereas IMF members have their own national currencies).² The main differences seem to be in the underlying rationale for the lending, the decision-making and staffing as well as the role the staff is playing in actual operations. These issues are discussed in the following two sections. Section 4 then turns to a speculation of the evolution of the need for a financial back-up for sovereigns, and section 5 makes a concrete proposal on how to give the ESM a slightly different function. Section 6 concludes.

² See for example the press report at: <http://www.reuters.com/article/us-eurozone-esm-idUSKBN16Q0SL>

2. DIFFERENCES BETWEEN THE LENDING RATIONALES OF THE IMF AND THE ESM

The International Monetary Fund (IMF) has two broad functions, whose relative importance changes greatly depending on the circumstances. During tranquil times in the global economy, the IMF represents the premier forum for the analysis and discussion of global economic developments. There exist of course other fora, such as the G-7 and the G-20, which also engage in high-level discussions of global economic issues, but none of them has the permanent highly qualified staff and the universal membership of the IMF. In Europe this function as a forum and of surveillance is performed by the Commission and the Council together with a large array of sub-groups and committees which ensure that high ranking officials meet their counterparts from other EU or euro area countries, on a regular basis.

The more attention-catching function of the IMF is to provide a backstop for countries in balance-of-payment difficulties. With the outbreak of the financial crisis, this function has again dominated the image of the IMF, especially in Europe where the Fund, as it is often called, has participated in four rescue programmes. This participation in rescue programs within a monetary union constituted a novel experience for the IMF as well. Its own internal evaluation office (IMF Evaluation Office (IEO)) has provided a somewhat critical review of the operations of the IMF in Europe³.

There are subtle differences in the (official) underlying rationales given for the backstop or rescue functions of the IMF and the ESM. In principle the IMF provides financing to cover temporary-balance-of-payment difficulties. The aim is to help countries. The ESM, by contrast, has been designed to intervene only if financial stability of the entire euro area is in danger. The purpose of the ESM is thus to safeguard the overall euro area, not to help individual countries. This can be done only as an *ultima ratio* when the entire system is in danger. The IMF does not operate under this constraint and has often provided financing even in the absence of any risk for global financial stability.

Another difference is of course the currency issue. The IMF can provide a country with external finance or foreign exchange when the country has lost access to international financial markets. The ESM does not formally provide ‘foreign exchange’ since it lends euros (to countries for which this is the domestic currency). In reality, however, debt in euro is in one respect similar to the foreign currency debt of a developing or emerging economy: the country in question does not have control over the currency (de Grauwe 2011). From an economic point of view there is thus little difference between the IMF providing Argentina with a loan in USD (or SDR) and the ESM lending euros to a euro area Member State.

Another subtle difference concerns the distinction between public and private debt. In some IMF programme cases, the external financing need arises in the first instance from the private sector (as for example during the Asian financial crisis of about 20 years ago). The ESM, by contrast, was explicitly designed to provide financing for governments in difficulties; with only a limited facility for direct bank recapitalisation added later. A government might face re-financing difficulties even if the country as such does not face an overall balance-of-payments deficit (as in Italy, for example).

In practice, the difference between a balance of payments crisis and a fiscal crisis is not that great since the IMF disburses its funding to governments, and the public sector usually runs large deficits if the country experiences a balance-of-payments crisis, even if the origin of the crisis is an imbalance of the private sector. There are two reasons for this. First, the government usually has little choice but to intervene and rescue major financial institutions once these run into difficulties. Second, economic

³ See IEO (2016), which noted that the IMF had “never articulated how currency union considerations should be incorporated in program design”.

activity tends to contract sharply with any balance-of-payments crisis; and this means government revenues fall. In reality a balance-of-payments crisis is thus usually also associated with a public-debt crisis. This is the background to the old adage that the acronym IMF stands for “it’s mostly fiscal”. Section 4 below will discuss in more detail how this aspect will be mitigated by financial market integration.

3. THE DIFFERENCE IN RELATIVE SIZE REQUIRES DIFFERENT MODALITIES OF GOVERNANCE

The governance of the ESM has been criticised because its lending decisions usually require unanimity, whereas only a qualified majority is needed in the IMF. The ESM Treaty also considers an emergency procedure under which a qualified majority of 85% of the capital would be sufficient to start a programme. But it appears highly unlikely that this emergency procedure would ever been used against the explicit vote of a member state.

The basic reason for this is that IMF programmes, even taking all of them together, are of an order of magnitude smaller, relative to the size of the global economy, than ESM programmes vis-à-vis the entire EU economy. Even a total loss on the IMF's biggest programme would mean only a negligible loss for its member states (and the monetary financing of IMF programmes should ordinarily have a negligible impact on the global money supply⁴). This is the reason why IMF programmes do not touch vital fiscal interests of the creditor countries, which can thus accept being put potentially in a minority.

There are a couple of reasons for this difference in relative importance:

- The countries that could conceivably require IMF assistance constitute a much smaller share of world GDP than the countries that might require assistance from the ESM. The shares of Italy or Spain in the euro area's GDP are (now) between 10 and 15%. This is much more than that of the biggest country that might conceivably need IMF assistance. At the global level, the largest countries are usually also providers of reserve currencies, which guarantee market access (and if the US, the euro area or China were to lose market access because the dollar, the euro or the RMB are no longer reserve currencies, they would be too big to save for the IMF anyway).
- A second reason is that (cross-border) financial integration is much stronger within the euro area than globally. The liabilities that might have to be re-financed by an ESM programme are thus much larger (relative to the GDP of the country needing assistance) inside the euro area and contagion effects will also be much stronger. Euro area countries have on average external liabilities equivalent to close to 400% of GDP, which is eight times more than emerging market economies (the main clients of the IMF until recently⁵). This aspect is documented more fully below.

Stronger financial inter-linkages have two implications.

In the first instance, the amounts to be financed by an ESM programme are larger (relative to IMF programmes). The aim of any ESM programme is to safeguard financial stability of the euro area. This implies that ESM programme had to cover the financing needs of the banking system as well. Until now this was done indirectly as the ESM lends to the government, which then props up its banks for example via capital infusions and/or guarantees for various liabilities. This was particularly the case for Ireland. If the Banking Union with the Single Resolution Fund and the bail-in rules of the BRRD become effective the need to re-finance the banking sector might be much diminished.

Secondly, contagion effects are stronger when intra-area cross-border financial linkages are so important. This implies that when a euro area country (and usually its banks as well) experience

⁴ The financing of the IMF is 'monetary', via the national central banks of its member states, but its function is mainly fiscal.

⁵ Over the last few years euro area countries have become the IMF's largest borrowers (and have financed most of its budget via interest rate surcharges and fees).

difficulties in accessing financial markets, this will have a strong impact on their cross-border counterparties.⁶

Of course, contagion operates also outside the euro area. This could be seen in the Asian crisis. But the fact that the crisis spread from one country to another was not due in the first instance to financial linkages between them, but because investors began to look for similarities across countries.

The combined result of all these factors is that the potential fiscal risks from rescue operations inside the euro area are much larger than from the operations of the IMF. The peak of the lending of the various euro area rescue mechanisms (including all the pre-ESM ones) was about €350 billion outstanding at the end of 2014, representing roughly 3.3% of euro area GDP⁷. By contrast, the total IMF credit outstanding during the Great Financial Crisis never went above 0.19% of global GDP, which is almost 20 times lower than the euro area value.

Figure 1 shows the evolution of IMF credit outstanding as a percentage of global GDP over a long period. During the 1980s, the IMF was more important, with its lending peaking at 0.3% of global GDP in 1985, at the height of the developing countries' lending crisis. The longer-term average is also below 0.15% of global GDP, implying that potential fiscal liabilities through IMF lending operations have usually been negligible for the creditor countries.

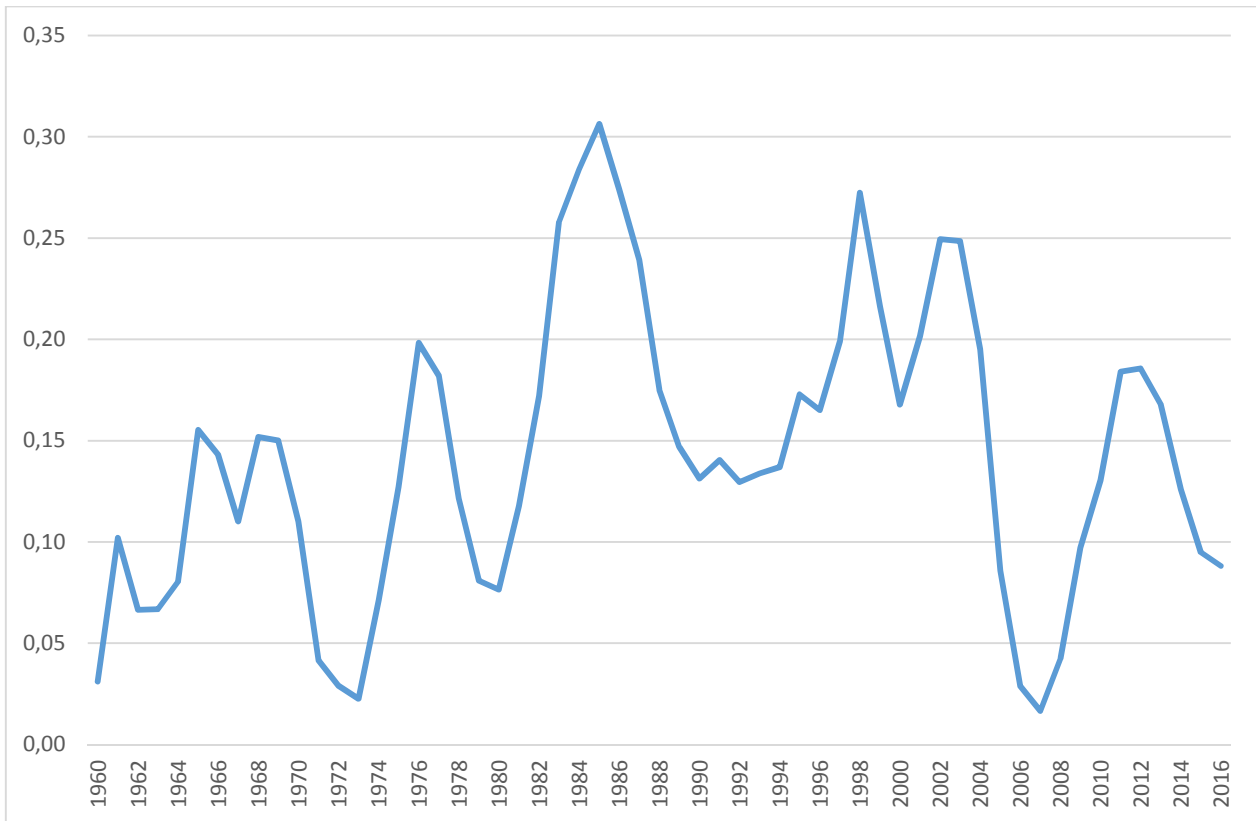
A third reason, hopefully temporary, why ESM programmes need to be large is that public debt in the euro area is generally much higher, as a proportion of GDP, than in the countries that typically might require IMF assistance. The average euro area public debt-to-GDP ratio now stands now at close to 90% of GDP. This is not far from the OECD average. But the euro area average is more than twice as much as that of the group of emerging economies. The countries needing assistance are typically the ones that have higher debt than the average among their peers, but it remains true that the public debt-to-GDP ratio of the euro area countries that have needed ESM assistance has been much higher than that of countries receiving IMF financial assistance only, e.g. Argentina and several Asian countries had public debt-to-GDP ratios below 50%.⁸

⁶ Tirole (2015) shows that these cross-border effects make bail-outs by the creditor countries optimal.

⁷ The exposure of the ESM has fallen to less than €250 billion (2.4% of euro area GDP) today.

⁸ See International Monetary Fund (IMF) (2016), "Debt—Use It Wisely", *Fiscal Monitor*, Washington, D.C., October. (<https://www.imf.org/external/pubs/ft/fm/2016/02/pdf/fm1602.pdf>)

Figure 1. IMF outstanding loans (% of global GDP)



Data source: IMF, International Financial Statistics.

The total size of the IMF quotas and the ESM capital are actually similar. The sum total of all IMF quotas is slightly below \$700 billion (460 billion SDR), which is equivalent to about 0.8% of 2015 global GDP. The capital of the ESM is €700 billion, which is equivalent to about 6.4% of (2015 euro area GDP).⁹ The effective lending capacities are in both cases somewhat lower than the capital (or its equivalent), but the relative differences remain. The lending capacity of the ESM is €500 billion, or about 4.5% of the euro area's GDP. The headline lending capacity of the IMF is supposed to be around €750 billion, but the actual 'forward commitment capacity' is much lower. And the actual lending is even lower, as a percent of global GDP, as shown below.

A final difference is that IMF lending is considered 'super senior', i.e. the IMF is to be repaid before any other creditor. This has contributed to a track record now spanning over half a century during which the IMF has never made a significant loss on its lending operations.

But super-seniority is the not the only reason why the IMF can be much more confident that its loans will be repaid. The key is that its lending is much smaller than the lending of the ESM. This is again related to the size of the quotas. As mentioned above, quotas are typically equivalent to less than 1%

⁹ The exact percentages change over time. IMF quotas were recently doubled. They were thus worth less than one-half of one percent of GDP until the last quota review (the 14th) came into force. The nominal capital (for the ESM) and the quotas (for the IMF) tend to remain unchanged for long periods of time. With nominal GDP growing, this implies that over time the fire power of both institutions will decline. But their relative importance should be rather stable. The fiscal risk as a percent of GDP will be higher for creditor countries with a GDP per capita below the euro area average since the shares in the ESM are based on the average GDP and population shares in the euro area. One should keep in mind that the euro area accounts now for less than one-sixth of global GDP. For the same programme size, this means a higher burden for euro area members. (The weight of the euro area in the global economy continues to shrink and might drop to around 10% by the end of the next decade.)

of GDP. For poorer countries they might be somewhat higher (around 1% of GDP) because one of the key elements in the quota calculation is GDP at purchasing power parity). Under the new rules adopted this year,¹⁰ access is limited to less than 5 times the quota, or roughly less than 5% of GDP. The ESM has no such limitation and in the case of Greece, the combined loans of the euro area partners (under the ESM, EFSF and Greek Loan Facility) amount to over 100% of GDP. The relatively small amounts loaned by the IMF imply that even a country in serious payments difficulty can still afford to reimburse the IMF. But this would not be possible for a future ESM programme if the size of the lending is anything like it is in the case of Greece. In the case of Portugal and Ireland the ratio of euro area to IMF financing was 'only' 2:1; but the general principle remains that IMF lending is much less important both for creditors and for debtors.

¹⁰ See <http://www.imf.org/en/About/Factsheets/Sheets/2016/07/14/12/21/IMF-Quotas>

4. DESIGNING THE ESM FOR THE FUTURE

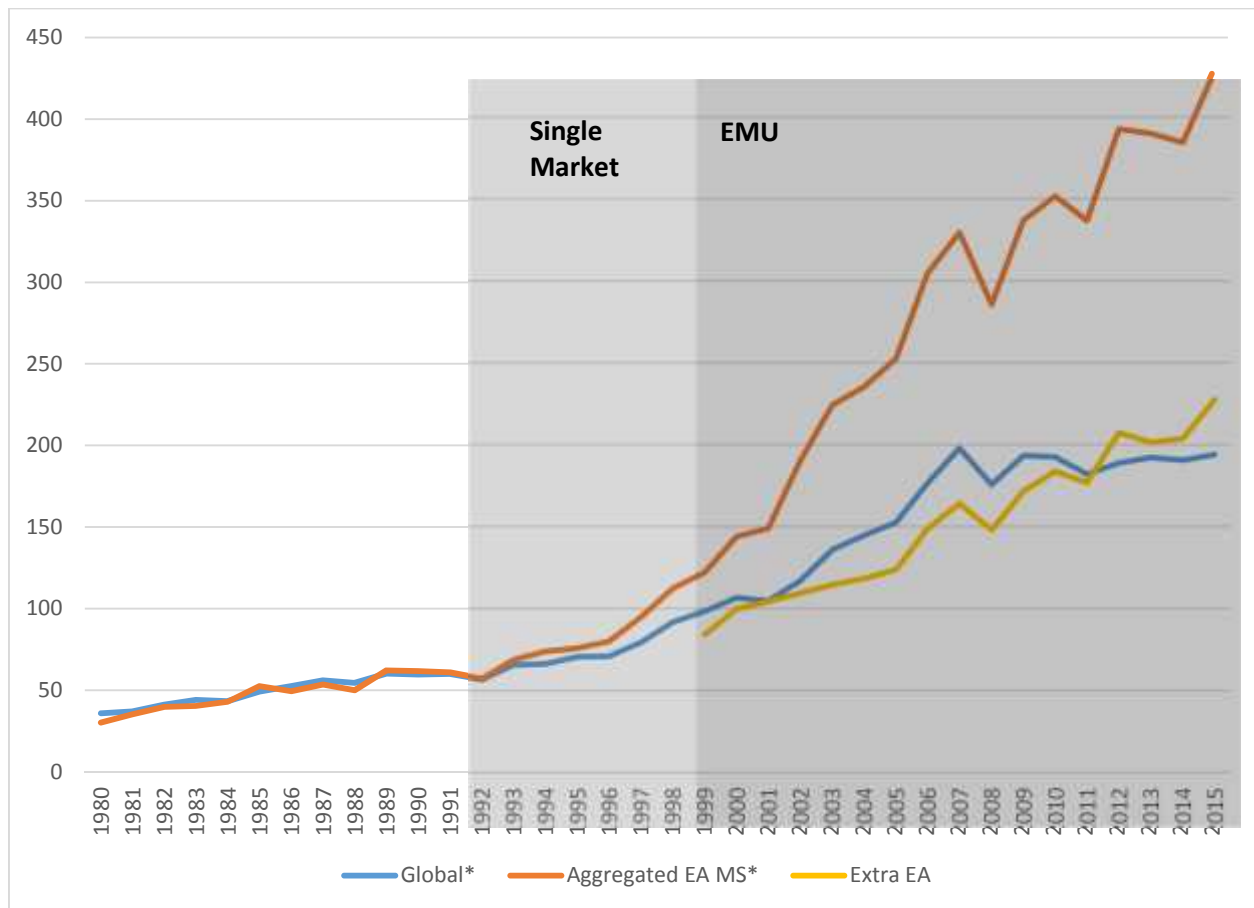
The evolution of the ESM should be seen in a broader and longer-term perspective, and not just viewed simply on the basis of today's environment. One key element in this context is the degree of integration of the euro area's financial system. But it is not clear whether a more integrated financial system will increase or diminish the probability that ESM programmes will be needed.

4.1 The trends so far

One key reason for the large size of existing euro area adjustment programmes is the sheer magnitude of intra-area cross-border financial assets and liabilities. Intra-area capital flows are difficult to measure since capital is generally fungible. But one rough measure of intra-area cross-border financial activity can be obtained by comparing the external assets of the euro area as a whole to the sum of international assets of the euro area countries taken individually. This is done in Figure 2, which shows three lines: i) the ratio of external assets to GDP for the euro area as whole (derived from its international investment positions (IIPs)), ii) external assets as a percent of GDP for euro area countries when one considers their IIPs individually, and finally, for comparison, iii) the global average of IIP assets to GDP. The importance of intra-area cross-border assets can be gauged by looking at the difference between the first two (the yellow and the red lines). This difference amounted to about 50% of GDP when the euro was introduced, but it has steadily increased since then and is now around 200% of GDP. If this trend continues, future financial crises might involve even larger financing needs.

The third line (blue) in Figure 2 shows that until about 1992, when the Maastricht Treaty was concluded, there was little difference between the average value for the world (IIP assets as a percent of GDP) and that of the (future) euro area countries. However, a difference emerged after capital movements were completely liberalised in the context of the Single Market programme. From the start of Economic and Monetary Union (EMU), most of the higher cross-border activity seems to have been intra-euro area, since the cross-border assets for the euro area as whole and those for the average of the entire world were quite close in 1999 and have remained of a similar order of magnitude.

Figure 2. A long-term view of the growth of cross-border assets in Europe (IIP assets as % of GDP)



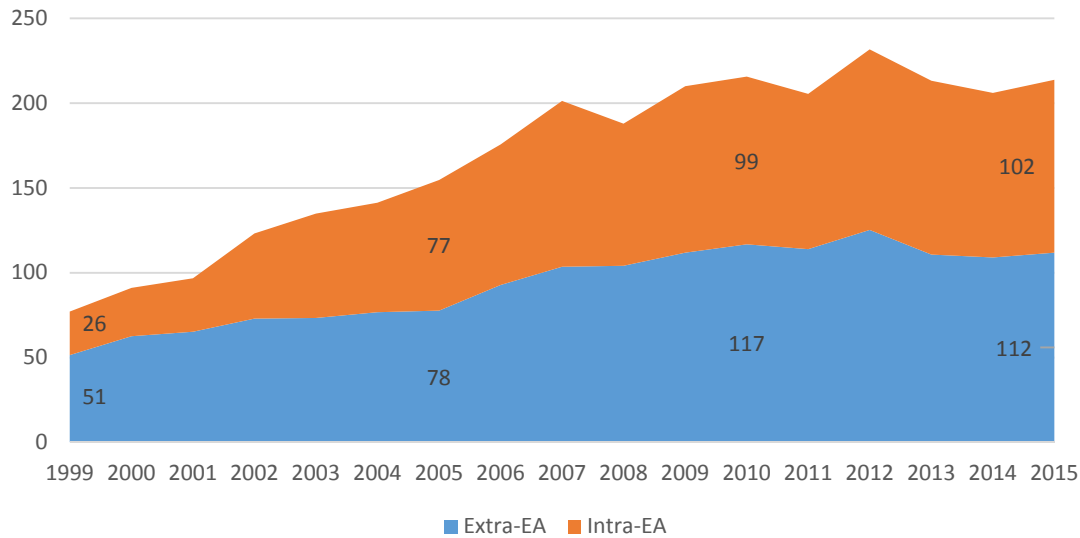
* For each year all available IIP data from the country group relative to the respective aggregated GDP.

Data source: IMF, World Economic Outlook database.

The euro area crisis has shown that debt is the category of cross-border financial flows that poses the greatest challenge to financial stability. Figure 3 therefore concentrates on cross-border debt flows¹¹ (i.e. all assets that are fixed in nominal amounts, like bank loans, other forms of debt and derivatives). It is apparent that at the start of EMU intra-area debt was not relevant since, at that time, most external debt was in dollars (and with financial centres, such as London or New York). However, after the introduction of the euro, intra-area debt (calculated here as the difference between debt external to the euro area and the sum of overall external debt of the aggregate of individual euro area member countries) increased from around 25% to over 100% of GDP. The growth of debt has considerably slowed down since the start of the financial crisis, and has now become somewhat irregular. Over the last few years there has even been some retrenchment, but the level of intra-area debt today is still higher than it was in 2008, and the aggregate debt level continues to climb, implying a high potential for financial crisis and thus a continuing need for a large ESM.

¹¹ A detailed breakdown between public and private debt is unfortunately not available for all years. However, the available data points suggest that the bulk was private debt. For example, in 1999 cross border, intra-area public debt was negligible (around 5 % of GDP), rising over time a little above 20 % of GDP, still a fraction of the total, both intra and extra-euro area.

Figure 3. Growth of intra-area debt (debt stocks as % of GDP)



Source: Own calculations based on IMF and Eurostat data.

4.2 Scenarios for the future

It is very difficult to gauge the course of financial integration in the euro area and its impact on the need for a large, potentially larger, ESM. If the longer-term trend of increasing cross-border debt were to continue, future ESM programmes might even need to be larger than the present ones, making it even more difficult to render the decision-making of the ESM closer to that of the IMF (because the burden on creditor countries would be so large that decisions could not be delegated to the technical level).

But a different scenario is also possible. For example, more cross-border banking consolidation could lead to a banking system that is more integrated and one in which idiosyncratic shocks in one country would not necessarily lead to a banking crisis in the country concerned, as the large banks could offset losses in one market with profits elsewhere. Moreover, experience has shown (Belke and Gros, 2015) that cross-border banking integration via ownership stakes is stabilising, as the headquarter banks can take a long term view and usually do not to cut their subsidiaries off from credit flows.¹²

By contrast, as argued above, integration of the banking market via inter-bank lending, which is often short-term, would be de-stabilising as the banks in a country with difficulties might be cut off from short-term credit, thus exacerbating the local downturn.

Another scenario is also possible. One reason for the large size of the euro area adjustment programmes is the dependency of the economy on bank financing and the large size of the banking sector in Europe (see ASC, 2014). This dependency of banks should be diminished by the European Commission programme to form a Capital Markets Union (CMU), which should foster the development of pan-European capital markets for both debt and equity (Valiante, 2016). Full implementation of the CMU programme might reduce the size of future ESM programmes if local banking systems are smaller and more cross-border finance takes the form of equity or other market-based debt instruments (instead of bank loans).

¹² Perhaps even more importantly, the headquarters has full information about the real situation of its subsidiaries. Other lenders not have this information, which can lead to credit rationing under asymmetric information, as analysed by Stiglitz and Weiss (1981).

Full implementation of the EU Bank Resolution and Recovery Directive (BRRD) should in principle also reduce the need for public funding since it requires that the Single Resolution Fund can be used only if at least 8% of the liabilities (except equity) have been bailed in beforehand. Assuming full application of the bail-in rules, De Groen and Gros (2015) show that the target size of the SRF (about €55 billion) should be sufficient to deal with a financial crisis even as severe as the one experienced by the euro area over the last few years. Recent events in Italy, however, have shown that in reality governments remain extremely reluctant to allow a bail-in, mostly because of the political cost of inflicting losses on voters or other financial institutions that might hold the bail-able capital.

Others have argued, on the contrary, that the 'bail-in' provisions of the BRRD would increase contagion, making a financial crisis more severe and thus increasing the need for public funding. This might be the case if there had been no bank failure, and thus no bail-in of any liabilities, for a long time. Investors might then have come to the conclusion that bank liabilities represent safe assets in general. The sudden realisation that this is not the case when a bail-in is applied might then lead to widespread contagion via fire sales and greater financial instability. The financial instability could be particularly severe if bail-inable instruments are held by leveraged institutions that might face insolvency proceeding if their holdings are bailed in.

Completion of the Banking Union with a common deposit insurance scheme would diminish the danger of a run on domestic banks, thus reducing the risk of a broader banking crisis following, for example, another real estate boom-and-bust cycle. The BRRD, the SRF and a putative common deposit insurance scheme would all help to reduce one side of the feed-back loop between banks and the sovereign, namely weak banks that could require large financing from their sovereign.

But something could also be done to deal with the other side, namely the impact of a weak sovereign on the strength of its banks. At present, most banks hold large amounts of the debt of their own sovereign on their balance sheets. Setting limits on the concentration of the holdings of sovereign bonds would reduce the impact of a refinancing problem of the sovereign on its banks. All this should reduce the probability of a new financial crisis and the need for an ESM programme.

The conclusion that emerges is that measures to limit contagion and to break the link between banks and the sovereign are at least as important as reforms to the ESM.

A first key step would be to impose concentration limits on the holdings of sovereign bonds by banks. At present banks in many countries hold over two times their capital in bonds of one (their own) sovereign. This implies that financing difficulties of the sovereign will immediately have very negative implications for the banks. This needs to be changed (see also ASC (2015) and de Groen (2015) for precise calculations of the consequences of potential exposure limits). It is clear that these limits should be introduced gradually, maybe the concentration limits could even be applied only to new purchases of sovereign debt, thus allowing banks to keep their present exposure. The ESM in particular noted that "The effect of the new regulations on sovereigns depends on the modality and timing of the introduction. A gradual increase in the risk weights and a relatively long phase-in period could alleviate the pressure on sovereign debt markets and help avoid strained fiscal adjustments. In this way, both the banking sector and the sovereigns would have time to adjust, which could significantly lower the macroeconomic cost of the new regulations. Nevertheless, if banks frontload the regulation as was the case for some recent regulatory reforms, price effects might be substantial despite well-designed transition arrangements." (ESM (2016))

Second capital markets should be strengthened. Inter-bank relations still dominate to a large extent cross-border exposures. The Capital Markets Union project should thus be given priority, by looking especially at all obstacles to cross-border capital market and especially equity flows. Larger cross-border assets might not constitute magnifiers of financial crisis if they are not among leveraged

institutions like banks. Cross-border equity should even have a stabilising function because it is loss-absorbing without bankruptcy costs. Achieving an integrated capital market might thus potentially reduce the required size of ESM programmes, reduce contagion and allow for tougher conditionality.

Finally, governments need to stop interfering with the market for corporate control of 'their' banks. Cross-border banking groups would also help to break the link between the sovereign and the banks operating on its territory.

But the completion of the Banking Union would also raise the issue of the lender or guarantor of last resort for the common deposit fund and the Single Resolution Fund (SRF). A tighter integration of financial markets and more, potentially larger, cross-border banking groups would increase the risk being shared, but this would also increase the risk of a larger crisis, which would be systemic at the level of the entire euro area. In such a situation, the funding of the SRF might not be sufficient (especially if there continues to be strong political opposition to bail-in). In an area-wide banking crisis it might thus be necessary to have a back-up for the SRF, much like the back-up role now played by the US Treasury for the US Federal Deposit Insurance Corporation (FDIC), which was devised during the last crisis. The FDIC can now count on a line of credit from the Treasury of up to \$100 billion, which might be increased under certain conditions (consent from the Federal Reserve Board, for example) to \$500 billion. In this respect, it is worth observing that there is no federal mechanism in the United States for financial stabilisation nor does there exist a (domestic) monetary fund to rescue states in trouble. Annex 2 explores some reasons why this is the case.

A change in the ESM Treaty might be required to allow it to provide financing for the SRF, and this would constitute a major political step. It is thus difficult to see how the ESM could acquire this function in a gradual or evolutionary way and it is unlikely to transpire before the SRF has reached its full size and the Single Resolution Mechanism has assumed its full powers. But one should keep in mind that it took a financial crisis of unprecedented proportions for the US to arrive at the present situation in which the Treasury backstop for the FDIC was made explicit. Until the crisis there had only been political declarations that the FDIC would be backed by the 'full faith and credit' of the US.¹³

¹³ Congress, in 1987, passed a "Sense of Congress" to that effect, but such enactments do not carry the force of law.

5. THE ESM AND THE IMF

Considering the ESM as nascent EMF raises the issue of the relationship with the IMF. This has two aspects:

5.1 Is the IMF needed in the euro area?

It is sometimes argued that the ESM (or an EMF) is not really needed, given the existence of the IMF. It was argued above that the high level of intra-area cross-border finance implies that the IMF would probably not be sufficient to deal with a future crisis in the euro area. But the existence of two rescue mechanisms has important consequences for the incentives facing euro area leaders. Weder di Mauro and Zettelmeyer (2017) argue that regional financial safety nets might lead to unsound policies as countries perceive that, given the high degree of financial integration, the creditor countries would have a strong incentive to bail them out. The requirement in the ESM Treaty that the IMF be part of the programme seems to have been at least partially motivated by the fear of moral hazard.

The assumption was that since the IMF lends only to solvent states the ESM would then not be able to lend to insolvent euro area governments. Formally the ESM Treaty already also contains the rule that the ESM should help only solvent countries. As Weder di Mauro and Zettelmeyer (2017) also note, however, the experience of Greece has shown that a relatively large amount of official financing on sufficiently concessional terms can make almost any debt burden sustainable. A corollary of this observation is that the highly concessional terms of ESM financing might indeed increase moral hazard, i.e. the temptation of a highly indebted government to count on a bail-out by the ESM. The IMF rules, and the restrictions in the ESM Treaty itself, might be of little value if cross-border finance continues to expand, increasing the incentive for euro area countries to avoid the disruption resulting from a sovereign insolvency in a highly leveraged financial system. In reality, however, the political cost of accepting an ESM program is so high that it is unlikely any government would consciously speculate on a bail-out by the ESM given that accepting a program usually means the fall of the government itself.¹⁴

Moreover, even from a purely financial point of view, co-funding from the IMF does not make sense for existing ESM programmes at present¹⁵ since the IMF charges almost 3% more on its lending than the ESM. The higher interest paid by Greece and other euro area countries provides the IMF with additional income at the expense of the euro area taxpayer, since the ESM statutes make IMF credits senior to its own claims. Moreover, the IMF credits are usually much shorter term in nature than those of the ESM (at least today). This implies that ESM lending carries a higher risk than IMF credits.

For the present situation the logical conclusion from this mismatch between a substantially higher cost and seniority combined with the short-term nature of IMF credits is clear: the ESM should lend Portugal, Ireland and Greece (plus Cyprus) the funds necessary to repay as quickly as possible existing IMF credits to these countries. This would not increase the risk for the ESM (and thus for Member States) since these claims would be senior to its own claims anyway. The savings that could be achieved in this way would be substantial, in light of the fact that these three countries have IMF credit outstanding of about €25 billion. The cost of IMF credit is about 2–3 percentage points higher than ESM funding. The operation ‘send the IMF home’ would thus save the ESM (and therefore indirectly the euro area taxpayer) about €500-700 million per annum.

¹⁴ An indication of the very high political cost of accepting a program can be seen in the behavior of the Portuguese government in 2016/7: it prefers to pay a risk premium of over 300 basis points on longer term market debt, rather than accept a new ESM program which would provide the country with much more favorable financing terms.

¹⁵ And in future, unless the ESM charges a higher penalty rate than the IMF. For the present situation, see Gros (2016).

These considerations suggest two conclusions:

- i) Making future ESM programmes contingent upon a parallel IMF programme does not seem to offer great advantages in terms of credibility.
- ii) The participation of the IMF in existing ESM programmes might as well be discontinued given the high cost of IMF lending.

5.2 The ESM/EMF in the IMF

The purpose of the ESM is to safeguard financial stability of the euro area. Its main task is thus 'domestic'. Moreover, the ESM will probably have to carry most of this burden given that the financial contribution of the IMF would anyway remain marginal (relative to the sums the ESM can mobilise). It might thus be best to recognise this reality and abolish the (mainly politically motivated) requirement that any ESM programme should proceed in parallel to an IMF programme.

This would not require a big change in the ESM Treaty since the ESM might still benefit from collaborating with the IMF staff on the design of the programme and the debt sustainability analysis. All the references to cooperation with the IMF in the ESM Treaty could thus remain, and only the two references to the IMF programmes and the financial contribution of the IMF would need to be eliminated.

Another important aspect concerns the external representation of the euro area. Gros (2013) proposed that a revamped ESM could become the vehicle for a unified representation of the 'fiscal interests' of euro area countries in the IMF.

This would, inter alia, have the advantage of taking care of the inherent contradiction that the contributions to the IMF are considered a fiscal issue, and thus the preserve of Member States, while its actual financing is monetary and thus account for the books of the national central banks, although monetary policy is unified. In practical terms this does not matter that much given the relatively small size of IMF operations documented above, but a unification of the euro area members' quotas in the IMF and the bundling of the fiscal function via the ESM¹⁶ would offer important advantages.¹⁷

There is no contradiction between the idea that economic policy coordination and surveillance can remain with the Commission and the idea that the ESM might represent the euro area's fiscal interest in the IMF. Economic policy coordination within the euro area (and indeed within the EU) has developed a complex set of instruments and procedures, often at an annual or even higher frequency. This activity has little connection with the much less formal and less detailed global coordination process in which the ESM would participate via its membership in the IMF.

The advantage of having the ESM represent the euro area at the IMF is that the staff of the ESM would be informed of ongoing IMF programmes (on which it would have to prepare opinions for the ESM representative at the IMF) and could learn from their successes and failures. This experience would also be useful if the ESM needs to consider a new programme in the euro area itself.

¹⁶ Formally IMF operations are recorded on the balance sheets of the national central banks. This should be changed as well since EMF members are supposed to put their 'national' currency at the disposal of the IMF, but this national currency is now the euro. In principle only the ECB should be allowed to issue euros. A bundling of the fiscal consequences of IMF operations in the ESM would probably have to involve some prior bundling at the ECB.

¹⁷ For a broader discussion of the arguments for a unified representation of the euro area more generally, see Giovannini et al. (2012).

6. CONCLUSIONS

The creation of the ESM (and the other temporary bail-out mechanisms) was justified, both as a signal that the leaders of the eurozone were prepared to do ‘whatever it takes’ to save the euro, and because it corresponded to a pressing practical need. Its decision-making structure appears somewhat cumbersome, but this was difficult to avoid given the large sums involved. In four out of its five rescue operations, the country concerned was able to exit the programme.

There are enough different instruments to cover most short-term contingencies. In a short-run perspective, the current set-up is not ideal, but it seems adequate.

The ESM seems to be building up the technical staff necessary to monitor and design programmes on its own as staff numbers have increased considerably since the institution was created.¹⁸ Given that only one programme is still ongoing, the ESM would not need a very large staff to be able to monitor the limited number of potential ‘candidates’ for future or renewed programmes. The main question is whether the finance ministries which dominate the decision-making in the ESM will allow this build-up to continue and give more leeway to the staff. But at any rate, no big formal decisions would be needed to allow this to happen and thus allow the ESM to be the equivalent of a European ‘Monetary Fund’.

When the euro area was caught unprepared by the Great Financial Crisis, it was paramount to create the safety net quickly and ensure that it had sufficient fire power. Attention should now shift from crisis management to crisis prevention. The first step is to endow the ESM with its own professional staff and analytical capacity. The next step will be to provide a framework for the division of labour and cooperation between the ESM and the Commission. This will not be easy, certainly from a formal point of view as long as the ESM remains an inter-governmental institution.

One danger to avoid is creating a situation in which the ESM staff has nothing to do, possibly for decades until the next crisis arrives. Another danger to guard against would be the rise of constant rivalry between the Commission and the ESM if the two are performing the same function. An acceptable compromise would be that the Commission remains responsible for coordination and general surveillance in the context of the existing institutions and procedures. The staff of the ESM, however, would be involved in those aspects of surveillance that concern dangers to financial stability.

This would seem appropriate in particular for the Macroeconomic Imbalances Procedure (MIP), whose purpose is to prevent economic and financial crises by monitoring a number of parameters that in the past have usually signalled a potential financial crisis. Responsibility for preparing the reports under the MIP might thus be shared between the Commission and the ESM. The ESM might then also be involved in drawing up any ‘corrective action plans’ that the Council might require from countries identified as having ‘excessive imbalances’. The need to enable a formal involvement of the ESM in these Union procedures provides another argument to bring the ESM Treaty into the overall EMU governance framework and thus into the Treaty. (A first argument would be that this would also strengthen the democratic accountability of the ESM itself, see Alcidi et al. 2014 and Alcidi et al. (2017)).

¹⁸ The 2015 Annual report says, “the ESM reached a total of 156 staff, secondees, trainees and interims at year-end. It is set to grow to a final headcount of 169, excluding trainees and interims, in 2016”. (see p. 105 of <https://www.esm.europa.eu/sites/default/files/esm2015annualreport.pdf>). Personnel costs have increased from less than €14 million to over €2.5 million in 2015. See also <https://www.esm.europa.eu/sites/default/files/esm2013annual-report.pdf>

In the longer-run, the ESM should certainly evolve further. But the term ‘European Monetary Fund’ might not be appropriate to describe what is most needed. In principle the need to provide financial support to member states should diminish over time under the combined influence of the Fiscal Compact, the Banking Union and the Capital Markets Union. Under the Fiscal Compact public-debt ratios should in principle decline continuously, at least towards 60% of GDP. This alone would diminish the need for an EMF. The Banking Union, combined with the bail-in rules of the BRRD, should in principle significantly reduce the pressure on national public finances in the event that a banking crisis erupts. The Capital Markets Union should in principle lead to more cross-border financing in the form of FDI, equity and other forms of long term capital, thus reducing the potential for ‘sudden stops’ in cross-border capital flows. Moreover, an integrated capital market would also make it more likely that the ‘bail-inable’ capital will be distributed across borders, entailing a further degree of inter-country risk sharing.

If all these elements were fully implemented, the ESM might never be needed to provide financing for member states. In reality, however, none of these three elements is likely to be fully implemented; and a number of member states will remain in a precarious situation with large public debts, banking systems nationally concentrated and most cross-border financing in the form of debt. The back-up function of the ESM for euro area sovereigns will thus remain important for some time to come.

To the extent to which the combination of Banking Union and Capital Markets Union leads to an integration of financial markets, the risk of local banking crises should diminish, but that of a generalised crisis at the euro area level might increase. This implies that at some point it would be important for the ESM to become the back-stop for the Single Resolution Fund, which should make the direct recapitalisation instrument redundant. The same should apply to the common deposit insurance, if it is ever created. Moreover, member states could pool their IMF quotas in the ESM, paving the way for a common representation of the euro area in the international financial institutions.

The ESM should thus be viewed more broadly as the nucleus of a euro area fiscal instrument for financial stability and, more generally, as an institution that can represent the common fiscal interests of the euro area abroad, especially at the IMF. But reforms of the ESM make sense and can succeed only if other measures are taken to reduce the potential for further crisis by reducing leverage both in the private and public sectors.

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ANNEX 1: COMMENTS IN RESPONSE TO GROS AND MAYER (2010)

From 'Free exchange' in *The Economist*:

OVER the past few days, several economists, both in America and Europe, have weighed in on Daniel Gros and Thomas Mayer's [proposal](#) for a European Monetary Fund (EMF). They have raised questions both about the need for an EMF in principle, and about its feasibility and usefulness in the present context, i.e. Greece's troubles. I think it's fair to say that Messrs Gros and Mayer's ideas came in for a good deal of criticism from our invited experts on all these counts.

The guest piece argued that:

"The difficulties facing Greece and other European borrowers expose two big failures of discipline at the heart of the euro zone. The first is a failure to encourage member governments to maintain control of their finances. The second, and more overlooked, is a failure to allow for an orderly sovereign default."

Our commentators were by and large unconvinced that there was a need for a new institution to do what existing institutions were already doing bits of. This applied particularly strongly to the idea of the EMF as a way to enforce fiscal discipline.

Desmond Lachman [wrote](#):

"What is even less clear is why Gros and Mayer would want to reinvent the wheel by creating a European Monetary Fund, when one has the International Monetary Fund that already has the expertise to impose the appropriate conditionality on lending to wayward countries like Greece."

But maybe the EMF would do a better job than the IMF? Edwin Truman was sceptical, saying that "if the EMF were tougher than the IMF is on average in terms of its economic and financial conditions, then Euro area countries would prefer to go to the IMF for assistance".

Tyler Cowen [argued](#) that the "underlying problems of European multilateral governance" are unlikely to "be solved by creating an entirely new and different institution". He would rather the ECB were reformed by broadening its focus beyond price stability, than an EMF set up. Carmen Reinhart [worried](#) about the ECB and the EMF (if one were indeed to be set up) butting heads.

Our commentators were also not convinced an EMF would work. Roberto Perotti, for example, [argued](#) that:

"(B)y the authors' calculations this facility would today give Greece access to something like .65 percent of its GDP ... plus any additional discretionary fund from the pool of all accumulated savings. However, 65 percent of GDP would make no difference to Greece today; and ... the intervention needed would eat up the whole fund just for a small country like Greece. The key problem country, Spain, with a public debt just above the Maastricht level this year, would have made virtually no contribution to the EMF. In the end, effective intervention, especially when the risk of contagion is high, is likely to depend on the discretion of Germany and other non-problem countries, just as it does now."

Ms Reinhart, though, was a bit more supportive of the second bit of the proposal, relating to orderly sovereign defaults. She argues that a regional institution would indeed "be filling a gap in the existing financial architecture". But she would like their proposal to go beyond sovereign debts to thinking

about how to sort out" the messy blur that currently exists between public and private debts: the "quasi-sovereigns"" During crises, she points out, "private debts often become public ones".

Then there is, of course, the question of feasibility, given where we are now. Could such a fund even be set up? Several commentators pointed out that any negotiations to set up a new institution would be protracted and messy. Mr Lachman argues:

“(I)t is fanciful to think that markets will patiently hold onto their Greek paper while the Europeans take their sweet time to set up as far-reaching an institutional change as Gros and Mayer are now proposing.”

Mr Cowen also argued that conditions are hardly ideal for the negotiations surrounding an EMF-type institution - winners and losers are too clearly known *ex ante*, whereas ideally such negotiations would be done behind a "veil of ignorance". More generally, several experts argued that the problem is a political one, not a technical one: what needs to be done is known; how to do it is a matter of politics.

So what might be done? Mark Thoma [suggested](#) fiscal federalism could serve as part of a solution to the eurozone's problems, but was realistically pessimistic about its prospects. But most would appear to agree with Jean Pisani-Ferry, who [wrote](#):

“The real choice at least in a first step is between IMF and EU assistance. As the EU in this respect has no legal basis, no mechanism, no financial instrument and no track record, a strong case can be made for calling in the IMF.”

Source: http://www.economist.com/blogs/freeexchange/2010/02/emf_roundtable_9?zid=294&ah=71830d634a0d9558fe97d778d723011d

ANNEX 2. WHY NO ‘AMERICAN MONETARY FUND ?

The institutions of the United States have served as the principal model for many structural aspects of Economic and Monetary Union in Europe, and many plans for the completion of EMU – for example, the introduction of fiscal shock absorbers or area-wide unemployment insurance – point to the US experience as a justification. But there has been little discussion of the lessons to be learned from the history of state finances in the US.

In the 1840s, a number of US states defaulted on their (mostly foreign) debt. There were petitions to Congress to provide them with financial support, but this was rejected. In the wake of this experience most states adopted balanced budget amendments obliging their own legislatures to follow prudent policies in order to convince investors that they would be able to service their debt.

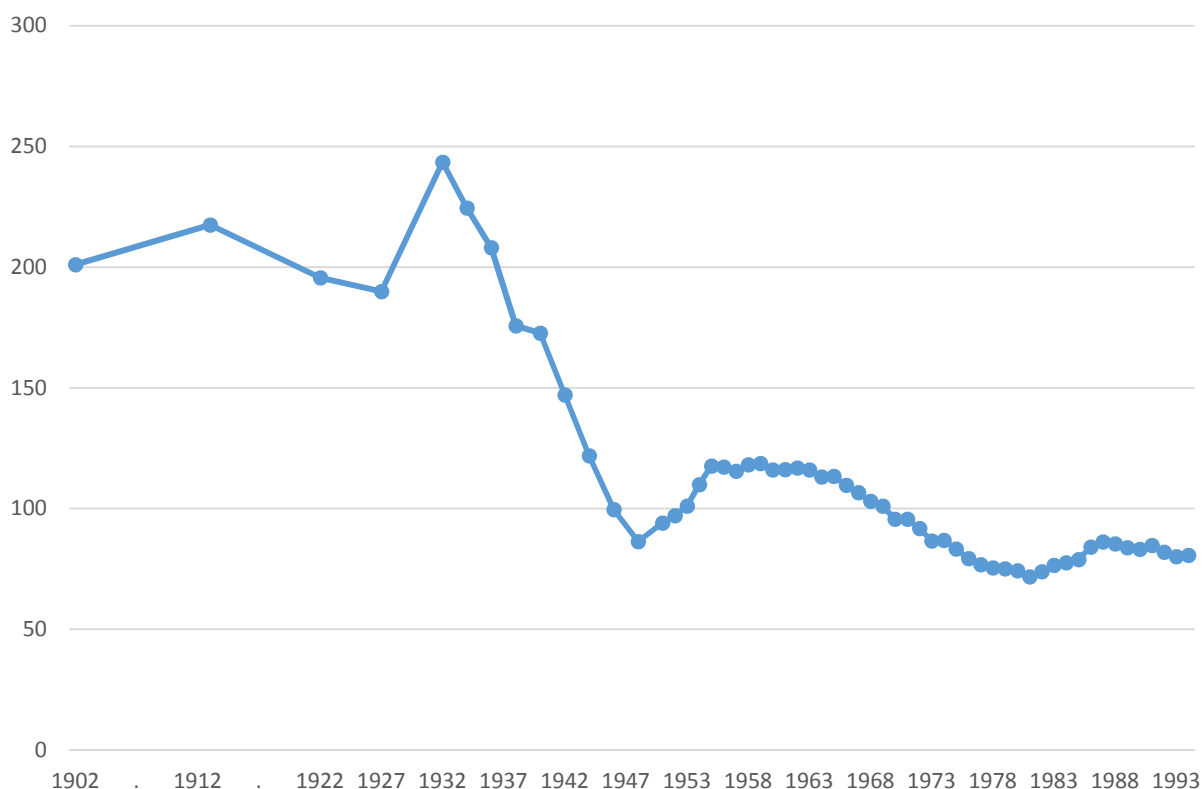
The US has never had any federal mechanism to support individual states in financial difficulties. But, in principle at least, one should apply to individual US states the same analysis as is applied to euro area member states: For Texas, a debt in US dollars is also in a currency that the Texan state authorities cannot control and thus is also equivalent to ‘foreign exchange’ debt, as for Greece or Portugal. In principle, individual US states could also be subject to a loss of access to credit markets.

Municipal bonds, a term that encompasses bonds issued by states or other municipalities, are generally exempt from federal income tax (and often from state taxes as well). They constitute thus an attractive investment vehicle, but their importance has always been secondary to federal debt. However, one has to consider a US state’s debt in relation to the revenues it has and not in relation to its GDP, because it is the former, i.e. its revenue, that determine the state’s debt service capacity.

If one looks at debt service capacity in this way, the difference between the euro area’s general government debt and US state debt is not that large.

Figure A1 below shows the longer term evolution of the debt/revenue ratio for the aggregation of state and municipalities in the US (unfortunately, figures were not available for states and the sub-state level separately). It is apparent that, if viewed against their revenues, US states had accumulated considerable debt in the early part of the last century, with debt/revenue ratios above 200%. This suggests that balanced budget amendments were often not fully honored. Since that time, however, the debt/revenues ratio of individual states has declined considerably and on average today it stands at around 80-90%.

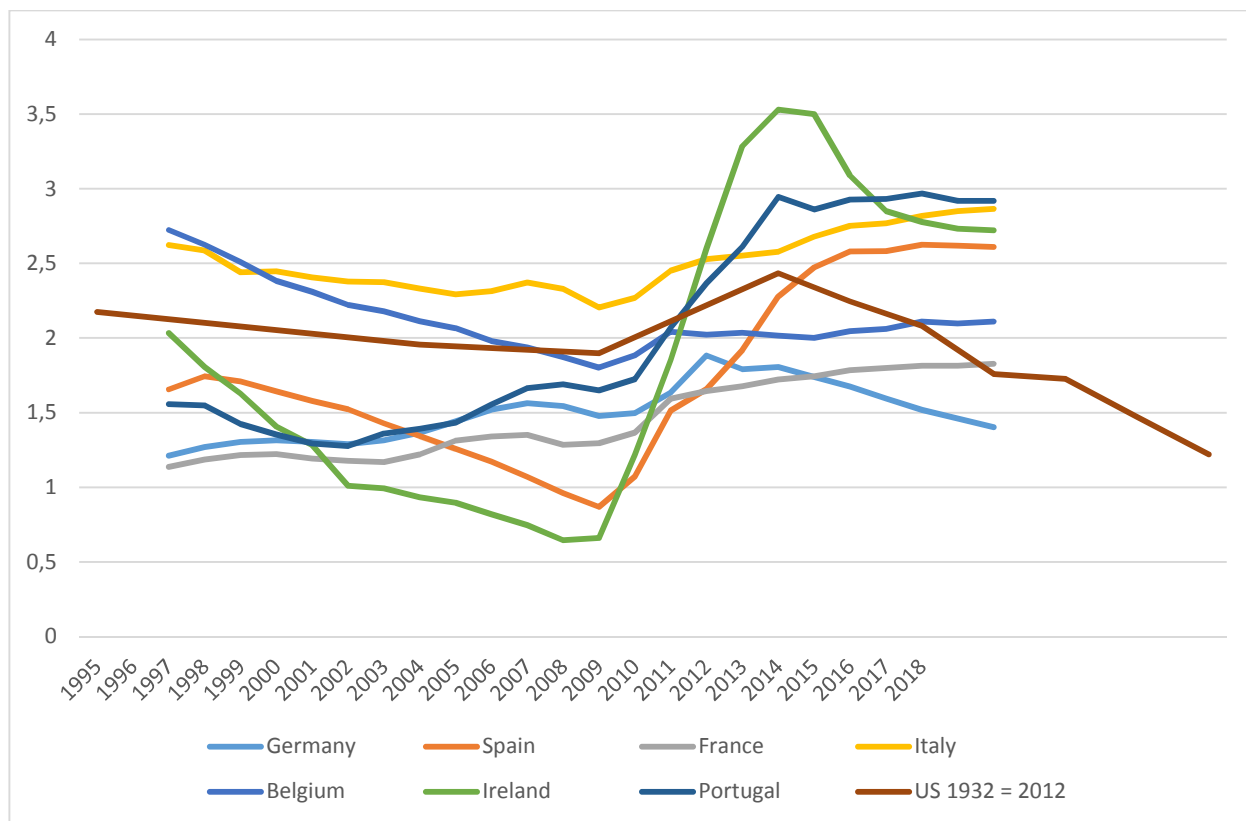
Figure A1. The longer-term evolution of debt at the sub-federal level in the US as a percent of revenues



Source: Author’s calculations based on Table Ea247-275, “Total government debt, by level: 1902-1996” and Table Ea125-131, “State and local government revenue, by source: 1902-1995”, in Carter et al. (2006).

Figure A2 shows the debt/revenue ratios for a number of euro area countries, four of which experienced financial stress (IT, PT, IRL, SP) and three of which did not (DE, BE, FR). It is interesting to note that the four countries that experienced financial stress had debt/revenue ratios above the peak of the sub-federal level in the US in the 1930s of about 250%, whereas those that did not have remained below this value. This euro area’s Fiscal Compact can be compared to the balanced budget amendments in the US as a reaction to the realisation of the high cost of a default. If the provisions of the Fiscal Compact on declining debt ratios were fully implemented, debt ratios in the euro area should over time decline first towards 60% of GDP. If the provisions on the cyclically adjusted deficit were also implemented, debt should then decline further towards even lower debt ratios, possibly achieving even the values of the US states today. Unfortunately, it seems that many euro area countries do not take the Fiscal Compact seriously because for them the ‘lesson learnt’ from the crisis has not been that high debt levels imply a danger of financial stress, but rather that a government needs to spend more to get its economy going again.

Figure A2. Debt/revenue ratios in selected euro area economies and the US



Source: Own calculations based on Eurostat data.

Another interesting instance of sub-federal financing in the US is that a private sector insurance mechanism developed in the late 1980s in the form of municipal debt insurance, such as AMBAC (American Municipal Bond Assurance Corporation), which provided insurance for issuers of municipal bonds, i.e. debt issued by states or lower-level entities. Initially only a small proportion of the municipal debt was insured this way, but over time this became more important. This line of business ended abruptly with the financial crisis of 2008-09 because the municipal bond insurers had engaged in large-scale operations in the securitisation of sub-prime mortgages (although they had been called ‘monoliners’).

In principle, a private sector-based insurance scheme should be possible in Europe as well, at least for the smallest Member States, whose debt is of a similar magnitude as that of some US states. The advantage of this type of private sector solution is that it provides investors with an asset of uniform quality. Investors in a bond guaranteed by an insurer can base their investment decisions on the rating and financial standing of the insuring entity and do not need to have detailed knowledge of the quality of the individual bond issuers. Ratings agencies provide similar standardised information, but the service provided by a bond insurer would be more ‘tangible’ in that it guarantees full payment. The bond insurer will naturally charge a premium to the entity that issues the bond, presumably based on the probability of a default (and the loss given default). The savings for the bond issuer might thus be limited, but for smaller states it might still be useful to use this service to open a wider market for their bonds.

Another difference between European and US states is that the latter, as lower-level government entities, can avail themselves of protection against creditors under Chapter 9 of the US bankruptcy code. But this protection comes at a cost: any entity invoking this provision must then also accept to be managed and overseen by a bankruptcy judge. When Puerto Rico recently became insolvent, it

attempted to be brought under a Chapter 9 procedure, but its claim was rejected owing to the fact that it has a special status (as an unincorporated territory of the United States as opposed to a ‘State’) (see Gros, 2015).

For the euro area, the desirability of a sovereign debt restructuring mechanism remains an open issue (see Fuest et al., 2014 or ECB, 2016 for a survey of the issues). If sovereign failures were frequent low-level events, one could argue that a set of rules could make the process more predictable for investors and the country concerned. Moreover, a sovereign debt restructuring mechanisms could also provide the ESM with a tighter framework for its own interventions. Sovereign insolvencies, however, are likely to remain very rare, occurring only in exceptional and politically highly charged circumstances. Moreover, euro area Member States remain fully sovereign countries. It is thus difficult to imagine norms or rules that could constrain them, especially under exceptional economic circumstances.

