

# Risks and opportunities of establishing a European Monetary Fund based on the European Stability Mechanism

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## Contents

|   |    |
|---|----|
| Abstract .....  | 3  |
| 1. Introduction.....  | 4  |
| 2. Proposals to strengthen rules enforcement and market discipline .....    | 5  |
| 2.1 Replacing the IMF (and the EU Commission) in crisis programmes .....    | 5  |
| 2.2 Strengthening fiscal and macroeconomic surveillance and rules .....     | 6  |
| 2.3 Establishing a sovereign debt restructuring mechanism at the EMF .....  | 6  |
| 3. Proposals for new tools for risk sharing and debt mutualisation.....     | 7  |
| 3.1 Flanking automatic stabilisers in recessions in stressed countries..... | 8  |
| 3.2 Enlarging the financial capacity of the ESM .....                       | 8  |
| 3.3 Providing a fiscal backstop for the Banking Union .....                 | 9  |
| 3.4 Establishing a ‘fiscal capacity’ in the euro area .....                 | 11 |
| 4. Reasons for basing an EMF on the ESM framework.....                      | 13 |
| 5. Conclusion.....  | 14 |
| References .....  | 17 |

## Abstract

The French presidential elections could lead to more fiscal integration in the euro area. The proposal to establish a European Monetary Fund (EMF) based on the European Stability Mechanism (ESM), which would probably be possible without treaty changes, is evaluated in this paper. Potential EMF instruments are divided into two categories. Firstly, to strengthen the rules-based EMU framework the EMF could not only replace the IMF in crisis programmes, but could also monitor the implementation of EMU rules by the EU Commission. However, problematic implementation issues could arise. Moreover, in order to strengthen financial market discipline, the EMF could become both platform and agent for an effective and reliable sovereign debt restructuring mechanism. However, as this idea will meet with considerable political resistance, it could probably be only a part of a larger political compromise.

Therefore, the EMF would, secondly, also very likely include features that raise risk sharing and debt mutualisation – even though the author is sceptical about several of the following instruments. Generally, it would make sense to establish a new type of EMF crisis programme in order to allow stressed countries to let automatic stabilisers work under strict structural reform conditionality. Another proposal is related to the lack of the ESM's resources to finance a 3-year programme for a large EMU country. This problem could largely be solved by automatically extending the maturities of all outstanding sovereign debt of the stressed country for three years in case of a crisis programme. This would significantly reduce the financing needs of the EMF. The alternative solution, to considerably increase the EMF's finances, could endanger the creditworthiness of the EMF. The EMF could also be used as a common fiscal backstop for the Banking Union. However, this would also imply a large increase in risk taking. Therefore, exposure limits for the EMF would be needed and the bank-financed Single Resolution Fund (SRF) would have to be required to repay the EMF in due course. Finally, if a kind of 'fiscal capacity' was established at the EMF, it should be financed by contributions from EMU countries and the EMF should not be allowed to raise debt. Stressed countries should only receive interest-free loans with a longer repayment period and not transfers. This would reduce the EMF's financial exposure and would make national fiscal policies more countercyclical in good times.

Basing the EMF on the ESM appears to be the superior choice compared to the creation of a completely new institution, which is unlikely to have a similarly robust governance framework. However, the creation of an EMF would still be a considerable venture. Could the mechanisms for better rule enforcement and financial market discipline be made sufficiently robust? Would new instruments for risk sharing and debt mutualisation remain within the initial limits, or would they lead to permanent transfers and serious disincentives for fiscal and economic policy?

## 1. Introduction

Since the election of Emmanuel Macron as French president, the debate about further reforms of the governance architecture of the Economic and Monetary Union (EMU) has gained momentum. Macron proposes a common budget, a parliament and a finance minister for the euro area. Such reforms will only be realistic if they find sufficient support from the German side. However, not only government representatives from the SPD, the German Social Democrat Party, but also those from the Christian Democratic Union (CDU) see some room for more fiscal integration in EMU in principle. Wolfgang Schäuble, the German finance minister, has also proposed an EMU finance minister – in order to strengthen the fiscal rules in EMU countries. Nevertheless, a common budget, a finance minister and a powerful parliamentary representation for EMU countries would very likely require a change to the European treaties – which appears very unlikely in the short to medium term in view of the increased EU scepticism and the shift to populist parties in some EU Member States.

Therefore, another proposal of the German finance minister could be potentially more realistic: creating a European Monetary Fund (EMF) on the basis of the European Stability Mechanism (ESM). Treaty changes would probably not be needed because the ESM is based on an intergovernmental agreement that could be adapted accordingly, provided the EMU countries agreed on this reform. Moreover, Schäuble has vaguely proposed a consultative role for a euro area parliament – which would also be possible without treaty changes, if no clear decision-making powers were conveyed. The suggestion of creating an EMF can also be related to the conflicts with the International Monetary Fund (IMF) in the Greek rescue programme and the German proposal to introduce a sovereign debt restructuring mechanism. Moreover, there has been talk that a strong EMF could potentially control the European fiscal and macroeconomic rules in a more reliable way than the European Commission, which has generously interpreted these rules in recent decisions to the frustration of the German government.

The creation of an EMF could potentially form the basis of a Franco-German political compromise to reform EMU governance. The likelihood of this would increase if Macron contributed to re-establishing trust in Germany by making France adhere to the Stability and Growth Pact (SGP), as he announced. However, it is an illusion to believe that such an initiative would only use an EMF to strengthen the rules-based EMU framework and financial market discipline, aspects that are favoured by Germany and northern EMU countries. To make it politically viable, the EMF would also very likely have to include some of the risk sharing and fiscal integration features that the French Government and southern EMU countries propose. The big question

is: Will both sides agree, after the elections in Germany, on a compromise and enlarge the capacities of the EMF in these two directions?

Against this background, this paper evaluates the opportunities and challenges of creating an EMF. As there is no clear concept of how an EMF would look, the author has to rely on assumptions about its objectives and elements. This paper will provide the reader with insights and arguments that should be taken into account when the establishment of an EMF is considered.

## **2. Proposals to strengthen rules enforcement and market discipline**

### **2.1 Replacing the IMF (and the EU Commission) in crisis programmes**

In rescue and reform programmes, the EMF could, in principle, replace the IMF as well as the other institutions that, together, were formerly known as the Troika (the IMF, the EU Commission and the European Central Bank, ECB). This proposal would have several advantages. The coordination costs and conflicts between the institutions would vanish. Moreover, if the EMF was sufficiently autonomous, the conditionality principle would be strengthened because the politically influenced EU Commission would no longer be involved. Sufficient accountability could be guaranteed by requiring the EMF to report to a consultative euro area sub-formation of the European Parliament.

Yet this construction would also have potential disadvantages, because sufficient technical expertise and staff would have to be provided to the EMF. Finding experts with similar expertise to the IMF will be difficult, however, because only the IMF has had such a depth of experience with crisis programmes. Moreover, the EMF experts would remain idle if none of the Member States had a crisis. So the question arises as to whether the EMF – like the IMF – should also be tasked with the continuous monitoring of EMU countries also in non-crisis times in order to keep the staff busy and relevant. However, this would create considerable redundancies and additional costs because the IMF, the Organisation for Economic Co-operation and Development (OECD), the EU Commission, and also to some extent the ECB already perform this task. To avoid this drawback, the EMF would have to rely on a small staff in non-crisis times.

In this scenario, the question arises as to whether the involvement of IMF expert staff should be continued in a crisis, but on a smaller and less political scale. It might be possible that this could be achieved by restricting the IMF financial involvement to a

minimal contribution. However, it is questionable whether the IMF would agree. Moreover, this solution would contradict the basic intention that Europe should be able to solve its problems on its own.

Alternatively, the EMF could potentially be allowed to borrow staff from the EU Commission or the ECB when a crisis arises. This staff could work under the clear leadership of the EMF staff in order to guarantee sufficient independence.

## **2.2 Strengthening fiscal and macroeconomic surveillance and rules**

The EMF could be tasked with improving the adherence to European rules (provided it was equipped with sufficient staff to continuously monitor EMU countries). However, it appears hardly imaginable that an EMF could take over formal powers from the EU Commission because this would very likely require treaty changes. But EMF analyses could possibly raise the pressure on the Commission to enforce the fiscal and macroeconomic rules more strictly.

However, this idea would not work without certain changes to the rules. Currently, for example, the ECB publishes critical evaluations of the Commission's fiscal and macroeconomic surveillance, but this does not seem to influence the Commission to any sufficient degree. Moreover, the Commission established the new European Fiscal Board also in a way that does not significantly restrict its own leeway. Therefore, the Commission's guidelines would have to be changed so that it has to take into account the EMF's reports. The question is whether this could be done by adjusting secondary legislation and without treaty change.

## **2.3 Establishing a sovereign debt restructuring mechanism at the EMF**

The EMF could provide the platform for a sovereign debt restructuring mechanism, as suggested by Matthes/Schuster (2015) for the ESM in order to strengthen financial market discipline and the no-bailout clause. Accordingly, the EMF would provide the framework rules for the negotiations between the debtor state and its creditors, and would also – in a staged process – be provided with consultative and potentially also interfering rights in order to guarantee an effective and reliable outcome.

Under current rules, before an ESM programme is established, a debt sustainability analysis has to be carried out by the ECB and the Commission in liaison with the IMF. This task and additional competences could be conveyed to the EMF as part of this reform.

Moreover, if an ESM (EMF) support programme was required, it could be made obligatory that this step would automatically lead to a compulsory extension of the maturities of all outstanding sovereign debt securities of the respective crisis country for the period of the programme duration, while interest payments would have to be continued (Deutsche Bundesbank, 2011; Matthes et al., 2016). In formal terms, this would involve an automatic sovereign debt default, but with only a small reduction of the present value of outstanding debts. This proposal would have the advantage that the financial resources of the ESM (EMF) could be used much more effectively because credit payments would not have to be used for the repayment of outstanding debts (see section 3.3 for details). Thus, the EMF would be much more financially able to support large EMU members if needed.

However, an automatic trigger of a (partial) sovereign default can involve the danger that financial market actors anticipate an EMF programme and run for the exit, which would exacerbate the situation for the respective country. In that case, an EMF programme would have to be activated very quickly, based on the established emergency procedures of the ESM.

There must be no illusions: introducing a sovereign debt restructuring mechanism to reinforce the no-bailout rule will make financial market actors apply more scrutiny and will likely lead to higher risk premiums for sovereign debt, particularly for countries with high public debts and deficits – which is exactly what market discipline means. In order to limit financial market turbulences, the introduction of a sovereign debt restructuring mechanism needs to be very well prepared and carefully handled.

### **3. Proposals for new tools for risk sharing and debt mutualisation**

Next to employing an EMF to strengthen rules and market discipline, other suggestions for new instruments to fight future crises have been brought forward, most of which would imply more risk sharing or debt mutualisation. In the following sections, a selection of proposals is presented and briefly evaluated.

### 3.1 Flanking automatic stabilisers in recessions in stressed countries

Due to the lasting impact of the euro debt crisis, public debt ratios of several formerly stressed EMU countries will remain elevated for a longer period. Thus, it cannot be taken for granted that these countries will be sufficiently able to fight future recessions. Instead, the financial markets could potentially become jittery and raise risk premiums by a wide margin if public deficits rose as a result of these countries attempting to let automatic stabilisers work.

As proposed for the ESM (Matthes et al., 2016), a new form of financial support (and reform) programme could be designed, which would not require strict fiscal consolidation, but allow the working of automatic stabilisers. However, in order to avoid disincentives, such a programme would have to be only available to countries that ex ante adhere to the SGP rules. Moreover, it would have to be strictly based on the conditionality principle based on a memorandum of understanding. Required reforms would not focus on austerity, but on structural reforms. These reforms should focus on product (and labour) markets in order to strengthen economic growth and employment – thus aiming at regaining confidence with financial market actors. Growth-enhancing reforms could also target other areas, for example a rebalancing of government spending and taxation towards more inclusive growth.

### 3.2 Enlarging the financial capacity of the ESM

With its current financial resources, the ESM would hardly be able to finance a traditional 3-year-programme for several countries (including a larger one) at the same time or, as an example, for Italy alone. With the current free forward commitment capacity of EUR 375 billion (ESM, 2017), the ESM could not cover the large refinancing needs of Italy with a total public debt burden of more than EUR 2 200 billion and with an average maturity of around 6.5 years (Dipartimento di Tesoro, 2017a). In fact, in the final three quarters of 2017, sovereign bonds amounting to nearly EUR 350 billion have to be retired (Dipartimento di Tesoro, 2017b). In addition, the figure for 2018 is EUR 213 billion, and in 2019, EUR 185 billion.

Thus, it does not come as a surprise that an extension of the ESM's lending capacity has been discussed (EP, 2017) with regard to the creation of a budgetary capacity for the euro area. However, if the ESM (EMF) was provided with the ability to finance a 3-year-programme for Italy, for example, the refinancing needs alone would amount to more than EUR 750 billion (Dipartimento di Tesoro, 2017b) between 2017 and 2019 (this is excluding the financial needs to cover any fiscal deficits). A

debt mutualisation of this size could also endanger the creditworthiness of the best-rated countries, which are key for the high credit rating of the ESM – and thus for its low refinancing costs.

Therefore, even if the ESM's lending capacity was extended, the above-mentioned recommendation should be adhered to, i.e. that at the start of an EMF programme, an automatic extension of the maturities of all outstanding sovereign debt securities should be obligatory (while interest payments would be continued). This would imply that the EMF would only have to finance the current fiscal deficit of (for example) Italy, which amounted to EUR 41 billion (or 2.4 per cent of GDP) in 2016 (EU Commission, 2017). Even if the fiscal deficit should reach 5 per cent of GDP during the 3-year programme period, the financial needs to be covered by the EMF would amount to far less than EUR 300 billion. This amount appears bearable for an EMF with (or without) an enlarged financing power.

### **3.3 Providing a fiscal backstop for the Banking Union**

The Banking Union is currently still incomplete - for good reasons. EMU-wide mechanisms for banking supervision and resolution are up and running, but there is still a significant lack of risk reduction which impedes an increase of risk sharing tools of the Banking Union, i.e. a common European Deposit Insurance Scheme (EDIS) and a fiscal backstop for the Single Resolution Fund (SRF) that is financed by limited contributions from euro area banks. These steps are intended to contribute to breaking the bank-sovereign nexus. As one side of the so-called 'doom loop', this nexus implies that crises of (large) national banks could endanger the fiscal sustainability of a national government when it (has to) rescue the failing bank(s).

To break this bank-sovereign nexus, several steps and reforms have been taken. In order to limit spillovers to national governments, euro area banks have significantly increased risk buffers and private investors should bear a larger part of the losses via bail-in requirements. However, an additional layer of risk sharing in EMU is still missing: if a bank fails, banks and governments from other EMU countries are meant to share potential losses via common deposit insurance and a common fiscal backstop. This last step is still hampered by large amounts of legacy assets in the form of non-performing loans (incurred during the crisis) that have not yet been cleared. Moreover, there is still a lack of initiative to sever the sovereign-bank nexus, the other side of the 'doom loop'. This nexus arises because problems of the sovereign could spill over to national banks as they often hold a large amount of their national government's sovereign bonds in their portfolio. They do so mainly because

of regulatory privileges for the sovereign bonds of euro area countries – mainly zero risk weights and no exposure limits.

From a political point of view, more risk sharing will only occur in parallel with a reduction of legacy assets and the de-privileging of sovereign bonds. This is true for the EDIS, which still meets with substantial resistance, particularly from Germany, as well as for the fiscal backstop for the SRF, which has already been agreed, but only in principle. Provided that risks are sufficiently reduced, the EMF (built on the ESM) could potentially be used as a fiscal backstop (and principally also for the EDIS).

However, compared to the key support tools of the EMF (mainly loans and the purchase of their national sovereign bonds), such a backstop function would incur a higher degree of risk sharing. The probability of losses would be much greater, because the EMF could probably be required to give guarantees to or acquire shares in troubled banks, or it could participate in the ownership of bad banks.

The risks to the EMF could be reduced if the SRF (which is financed by contributions from banks) was obliged to pay back any financial support received from the EMF over a certain time period. Moreover, an upper limit for the fiscal backstop could be considered. A parallel can be drawn with the ESM's direct bank recapitalisation instrument, which also entails the acquisition of shares of troubled banks. Due to the higher loss risk compared to loans or sovereign bonds, which principally have to be paid back in full, this instrument is strictly limited to a maximum amount of EUR 60 billion in total in order to protect the financial resources of the ESM.

As a more general note of caution, the potential disincentives of increasing fiscal risk sharing for the banking system have to be considered:

- While a reliable deposit insurance scheme may be helpful to avoid bank runs, there is evidence that banks with insured deposits tend to take greater risks (Calomiris/Jaremski, 2016). Regarding the expansion of the US deposit insurance in the early 20<sup>th</sup> century, the authors show that insured banks with higher risk profiles were able to attract deposits away from uninsured banks with lower risk profiles. They also state that the expansion of liability insurance has been associated with more unstable banking systems.
- Moreover, the question arises as to whether fully-blown risk sharing capacities of the Banking Union would not eventually lead to an implicit support for small countries with relatively large banking systems. While these countries profit from high tax revenues paid by the large national financial sector in good times, in the

event of a larger banking crisis they can only cover a small part of the incurred losses and would rely on the other EMU countries' paid-in resources to do so.

### 3.4 Establishing a 'fiscal capacity' in the euro area

The EMF could possibly also become a vehicle to implement a 'fiscal capacity' in the euro area without treaty changes. Several currently discussed proposals for an EMU budget could be theoretically envisaged for an EMF, be it a common fiscal mechanism to support EMU countries hit by idiosyncratic shocks, a common unemployment scheme or an investment scheme on top of the European Fund for Strategic Investments (EFSI) to limit the investment gap in several EMU countries. Moreover, the EMF's resource could be used to establish an appropriate fiscal stance of the euro area in case the national fiscal policies were unable or unwilling to achieve this goal. Alternatively, the EMF could use its budget to support EMU countries implementing structural reforms.

Obviously, the instruments considered in this chapter would be very far-reaching and would thus have to be based on a sound argument justifying their necessity. There are several reasons why the author holds the opinion that more fiscal integration is not indispensable to make EMU sustainable (Matthes et al., 2016; Mattheslara, 2016). In a nutshell, this conjecture is based on the following arguments:

- The euro debt crisis was too exceptional and its legacy problems too temporary to justify new fiscal integration tools of a permanent nature.
- The root causes of the crisis (mainly a financial boom leading to excessive private debt) have been tackled by reforms already taken and a limited set of reforms still needed, mainly in the financial sector.
- The problematic real-interest-rate effect and the one-size-does-not-fit-all problem of single monetary policy, which can lead to economic divergence among EMU countries, can be tackled by country-specific macroprudential instruments supported by the strong role of the Single Supervisory Mechanism (SSM).
- The functioning of EMU in the context of the optimum currency area theory is considerably better than often perceived and has been further improved by structural reforms, particularly in southern EMU countries.
- The introduction of a fiscal integration mechanism could tend to induce disincentives for reform and unwarranted permanent transfers.

In view of these economic considerations and of the diverging positions of EMU countries it can be questioned as to whether there would be the political will to create an EMF with such far-reaching instruments as highlighted at the beginning of this chapter. However, if a political decision were to be taken to significantly increase the fiscal integration in the euro area despite these caveats, important features of such a 'fiscal capacity' would have to be decided upon:

- Should a country aided by the EMF's 'fiscal capacity' receive a grant or an interest-free loan it would have to pay back over a longer time period? In the case of a grant, the EMF support would amount to transfers, which would increase the EMF's stabilisation properties in case of idiosyncratic shocks, but would put much more strain on the EMF's resources. The degree of risk sharing in the euro area would be substantially increased and the question arises as to whether in the longer run there will be countries in the role of net transfer receivers and providers. Therefore, either grants should be restricted to exceptionally deep crises or, if also minor recessions are to be targeted, interest-free loans should be chosen in the opinion of the author. This would keep the increase in risk sharing at bay and would make national fiscal policies more countercyclical because loans would have to be repaid in good times.
- How should a 'fiscal capacity' located at the EMF be financed? The (small) ESM currently finances its administrative spending largely by the small interest rate margin earned on the loans provided to crisis countries. An EMF would need a larger financial basis for several reasons. Even the limited option of interest-free loans would eliminate the interest rate margin as a key financing source. Moreover, if the EMF was to be provided with sufficient staff to monitor EMU Member States, even more financial resources would be needed. The same would be true, if the EMF support would come in the form of grants instead of interest-free loans. Several options are possible to cover larger financial needs: Member States' contributions, delegated own resources like in the EU budget or even the permission for debt financing of non-crisis-loan spending. The first option keeps the Member States much more involved and is more likely to be achievable on an intergovernmental basis. Delegating own resources to the EMF would make it somewhat more independent, but it might be somewhat challenging to divert a part of EU Member States' tax income to an intergovernmental organisation. The debt financing option for non-crisis-loan expenditures would require even more financial resources to service the debts and could amount to a significant increase in the extent of debt mutualisation. Thus, it is not recommended by the author.

#### 4. Reasons for basing an EMF on the ESM framework

If it is again assumed that some of the above-mentioned risk sharing and debt mutualisation mechanisms are created, the question arises as to what kind of governance framework should be chosen. Would creating an EMF on the basis of the ESM to host these instruments be a superior choice to establishing a completely new institution?

The ESM in its current form would provide a relatively robust governance framework for an EMF. The ESM is a relatively independent institution. As an intergovernmental organisation with a rather technical task, it is somewhat detached from political processes – and can be broadly compared to the IMF. This larger independence of the ESM compared to the EU Commission or the European Parliament is important because reform programmes often meet with considerable political resistance. However, the ESM is still subject to some political influences because it is (like the IMF) controlled by a Board of Governors and Directors made up of high-ranking representatives of (elected) governments of the ESM Member States, thus providing the ESM with sufficient democratic accountability in the eyes of the author. The political influences can become relevant in the case of larger controversies among ESM Member States, for example concerning sensitive decisions about financial support for stressed countries.

Therefore, it is important that the ESM's majority requirements are high – at least a qualified majority of 80 per cent for all relevant decisions (except for a capital call to avoid ESM losses). Decisions to establish a financial support and reform programme have to be taken by mutual agreement (unanimity); in the case of an emergency procedure an 85 per cent majority is required. This implies that Germany with a voting share of nearly 27 per cent and France with a share of more than 20 per cent have a de facto veto on all major decisions. Moreover, the German representative in the ESM can only cast a vote on a new programme with the consent of the German Parliament. It has to be noted that these decision-making rules deviate considerably from the much lower majority requirements in the European Council or the European Parliament.

Would these restrictive procedures be transferred to the EMF or would they be changed towards lower majority thresholds, which would facilitate decisions to grant financial support? Several arguments have to be considered in this respect. Criticism might be raised by proponents of more lenient procedures that the high majority requirements limit the EMF's capacity to act in case of need, that Germany and France should not have special rights or that the German Parliament should not have the last word on the conditions of support and reform programmes in other Member

States. Moreover, there have been strong demands to integrate the intergovernmental ESM into the European framework and to increase its accountability to the European Parliament (which might be possible somehow without treaty changes). However, moving the ESM (EMF) much closer to the political sphere (and lowering its majority requirements) could endanger the conditionality principle because reform programmes could be overly softened due to political resistance.

The design of the decision-making structures of an EMF would obviously depend on the respective political power of Member States favouring more fiscal integration and those more sceptical about such moves and fearing a transfer union. In this respect, it has to be borne in mind that the ESM rules were decided under the pressure of the crisis and thus in a situation of considerable political leverage of the latter group of EMU countries.

## 5. Conclusion

The election of Macron as French president could lead to more fiscal integration in the euro area. However, as treaty changes are not likely in the near future, establishing an EMF on the basis of the intergovernmental ESM might be a viable option, as suggested by the German finance minister. In this paper, the idea to create an EMF is evaluated based on assumptions about its possible objectives and tools. Proposals for these features are divided into two categories.

Firstly, suggestions to strengthen the rules-based framework and financial market discipline in the EMU include the proposal that the EMF replaces the IMF in crisis programmes, and that it monitors the implementation of EMU rules by the EU Commission, which has been rather lax in this respect recently. However, these proposals are no panacea. Only the IMF has a lasting experience with crisis management. Moreover, as crises occur only occasionally, should the EMF be allowed to borrow staff from the ECB or the EU Commission, or should it be provided with a sufficiently large number of staff that would remain idle in non-crisis times? In the latter case, the EMF could be given the task to monitor EMU countries in order to evaluate the implementation of EMU rules by the EU Commission. But this would create expensive redundancies, as there are already many international organisations tasked with country monitoring. Moreover, it is not straightforward as to how the EU Commission could be made to adhere to the EMF's criticism and recommendations.

An important additional proposal to strengthen financial market discipline (via enforcing the no-bailout clause) would be to use the EMF as both platform and agent in order to establish an effective and reliable framework for sovereign debt restructurings.

However, this suggestion will meet with considerable political resistance from highly indebted countries and, in all probability, could only be a part of a political compromise leading to an encompassing rearrangement of the EMU governance framework. In fact, it generally does not appear realistic to only provide the EMF with functions to strengthen the rules-based framework and market discipline.

Therefore, the EMF would, secondly, very likely need to include instruments to raise risk sharing and debt mutualisation in EMU – several of which have been evaluated in this paper.

Generally, it would make sense to establish a new type of financial support programme in case of a severe crisis, so as to allow stressed countries to let automatic stabilisers work under strict conditionality for structural reforms to foster growth.

At present the ESM's financial resources would not suffice for a full 3-year programme for a large EMU country. However, introducing the rule that an EMF programme would lead to an automatic extension of maturities of outstanding sovereign debt for the duration of the programme length should mainly solve this problem. While this step would imply a small sovereign debt default and could lead to some nervous reactions on the financial market, it would have the important advantage of significantly reducing the financing needs because no refinancing of outstanding debt would be needed. The alternative solution, i.e. to considerably increase the EMF's finances could raise the degree of risk sharing so much that also the creditworthiness of the best-rated countries would be endangered which are key for a high credit rating of the ESM (EMF).

A similar consideration is relevant regarding the potential use of the EMF as a fiscal backstop for the SRF (and the EDIS) because this proposal would also imply too large a risk exposure for the EMF. If such a backstop function was implemented despite this caveat, provisions would be needed to set exposure limits for the EMF and for the bank-financed SRF to repay the EMF in due course. More generally, risk coverage in the banking system should not be too encompassing as evidence suggests that this induces banks to take on more risks.

Finally, some kind of 'fiscal capacity' could be set up at the EMF. Several versions are imaginable, for example a fiscal stabilisation mechanism for idiosyncratic shocks. While the author argues that there is no need for more fiscal integration to make EMU sustainable, such a decision might be taken as part of a broad political compromise. In this case, the 'fiscal capacity' should be financed by contributions from EMU countries and should not be allowed to raise debt. The financial support to a stressed country should be provided not as a transfer but as an interest-free loan with a longer repayment period. This would reduce the EMF's financial exposure and would make national fiscal policies more countercyclical in good times.

If new risk sharing instruments were created at the EMF under relatively strict rules, the question arises as to whether these rules will be adhered to or whether they will be bent in times of crisis (a problem of time consistency). It is therefore essential to choose a sufficiently reliable governance framework for the EMF. Basing the EMF on the ESM appears to be the superior choice compared to the creation of a completely new institution that is unlikely to be similarly robust. In fact, the ESM has a strong governance framework with large majority requirements for decisions involving financial support measures. Moreover, as a sufficient independence is a precondition to uphold the conditionality principle, a new institution might be more prone to political influences than the ESM. However, political pressures could be envisaged that might water down these robust features of the ESM over time.

Overall, the creation of an EMF with some of the presented instruments would be a considerable venture that poses many important questions. Could the mechanisms for better rule enforcement and financial market discipline be made sufficiently enforceable and time-consistent? Would new instruments for risk sharing and debt mutualisation remain within the initial limits or would they eventually lead to permanent transfers and serious disincentives for fiscal and economic policy?

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