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A European Monetary Fund – Considerations of Design, Politics and a Preliminary Evaluation

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INTRODUCTION[1]

The creation of an EMF could potentially form the basis of a Franco-German political compromise to reform EMU governance and to strengthen fiscal integration.[2] 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 and as included in the election programme of the German CDU/CSU. However, it is an illusion to believe that such an initiative would only employ the 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 include some of the risk sharing and fiscal integration features that the French government and southern EMU countries favour.

In this paper, the idea of creating an EMF and its possible instruments are evaluated. As there is no clear concept of what tasks an EMF would be set, the author has to rely on assumptions about its objectives and tools.

POTENTIAL INSTRUMENTS TO STRENGTHEN RULES ENFORCEMENT AND MARKET DISCIPLINE

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 provided 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 that required by the IMF will be difficult, however, because only the IMF has had such a depth of experience in dealing 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 in non-crisis times in order to keep its 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 team of staff in non-crisis times. However, the question arises as to how the EMF could be adequately staffed in crisis times. There are no straightforward solutions to this trade-off:

– One option would be to continue the involvement of IMF expert staff, but on a much smaller and less political scale, i.e. with only minimal financial contribution by the IMF. This solution would require the consent of the IMF and contradict the basic intention that Europe should be able to solve its problems on its own, but this may be deemed acceptable eventually.
– Another option would be for the EMF 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. However, the expertise on crisis resolution in these institutions is still limited and would have to be further developed.

Strengthening Fiscal and Macroeconomic Surveillance and Rules

The EMF could be tasked with improving 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 increase the pressure on the Commission to enforce 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

[1] This article is an abridged and revised version of Matthes (2017).
[2] For a critical view on the allegedly indispensable need for more fiscal integration in the euro area, see Matthes and Iara (2016); Matthes *et al.* (2016).

fiscal and macroeconomic surveillance, but this does not seem to influence the Commission to any sufficient degree. Moreover, the Commission also established the new European Fiscal Board in a way that does not significantly restrict its own leeway. Therefore, the Commission's guidelines would have to be changed so that it must take into account the EMF's reports. The question is whether this could be done by adjusting secondary legislation and without treaty change.

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 and Schuster (2015) for the ESM. This reform aims to strengthen financial market discipline and the no-bailout clause. 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. In the case of unsustainable government debt, a sovereign debt restructuring would be initiated. 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 – see Matthes and Schuster (2015) for more details.

Moreover, if an 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 (for this proposal see Deutsche Bundesbank (2011) and 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. A debt restructuring with a haircut would not be needed, meaning that possible disruptions in the financial market should remain contained. In case of a run for exit by investors, 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. In the longer run, this is not a drawback but an advantage of this reform, because strengthening the no-bailout rule would support market discipline. However, in order to limit financial market turbulences, the introduction of a sovereign debt restructuring mechanism needs to be very well prepared and carefully handled.

POTENTIAL INSTRUMENTS TO INCREASE RISK SHARING AND DEBT MUTUALISATION

Apart from 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. As pointed out above, it cannot be expected that only the German (northern European) view will prevail when setting up an EMF with broad competences.

Rendering Financial Support Programmes More Effective

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 for the EMF, which would resemble a full programme, but would not require strict fiscal consolidation and instead would allow for the working of automatic stabilisers. However, in order to avoid disincentives, such an EMF programme would have to have some special features:

- It should be based on an *ex ante* qualification criteria and should only be available to countries that adhere to the SGP rules.
- Moreover, it would have to be strictly based on the conditionality principle, including 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 should also target other areas such as, for example, a rebalancing of government spending and taxation towards more inclusive growth.

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 375 billion euros (ESM 2017), the ESM (EMF) could not

cover the large refinancing needs of Italy, which has a total public debt burden of over 2,200 billion euros and with an average maturity of around 6.5 years (Dipartemento di Tresoro 2017a). In fact, at the end of 2016, sovereign bonds amounting to over 320 billion euros had to be retired in 2017 (Dipartemento di Tresoro 2017b). In addition, the figure was around 180 billion euros for 2018 and 2019, respectively.

Thus, it does not come as a surprise that an extension of the ESM's lending capacity has been discussed (EP 2017) in connection 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 have amounted to over 680 billion euros (Dipartemento di Tresoro 2017b) between 2017 and 2019 (this is excluding the financial needs to cover any fiscal deficits). A debt mutualisation of this size could endanger the creditworthiness of the best-rated EMU countries, which are crucial for the high credit rating of the ESM – and thus for its low refinancing costs. Therefore, the EMF's lending capacity should only be extended to a limited degree.

Another reform step would be much more effective in enlarging the reach of ESM (EMF). As mentioned above, at the start of a full-blown EMF programme an automatic extension of the maturities of all outstanding sovereign debt securities should be made obligatory (while interest payments would be continued). This would imply that the EMF would have to provide loans only to finance the current fiscal deficit of the stressed country, and not to refinance the retirement of maturing government bonds. Taking again the example of Italy, the fiscal deficit amounted to 41 billion euros (or 2.4 percent of GDP) in 2016 (EU Commission 2017). Even if the fiscal deficit were to reach 5 percent of GDP during the 3-year programme period, the financial needs to be covered by the EMF would amount to far less than 300 billion euros. Thus, this reform would significantly reduce the need to enlarge the financial power of the EMF.

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. However, 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 common fiscal backstop for the Single Resolution Fund (SRF). The lack of risk reduction in the euro area banking system concerns mainly large amounts of non-performing loans (incurred during the crisis) and a lack of initiative to sever the sovereign-bank nexus. This nexus arises because a sovereign debt crisis would 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. According to the political decision of the Ecofin (2016) from June 2016, in the near future progress on EDIS and on the SRF backstop will only be possible if significant risk reduction measures have been successfully implemented.

Provided that risks are sufficiently reduced, the EMF (built on the ESM) could potentially be used as a common backstop for the SRF. 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 imply a higher degree of risk sharing. The probability of losses would be far 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. Therefore, it is appropriate that the Ecofin (2016, 8) states that "the SRF backstop will be fiscally neutral over the medium term". This needs to be achieved by requiring the SRF (which is financed by contributions from banks) to pay back any financial support received from the EMF over a certain time period. In addition, an upper limit for the fiscal backstop should be considered.

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 and Jaremski 2016).[3]

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 of the proposals currently discussed 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, 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. In addition, the EMF could use its budget to support EMU countries implementing structural reforms.

Obviously, these instruments 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 and Iara 2016; Matthes *et al.* 2016).

[3] As far as the expansion of the US deposit insurance in the early 20th century is concerned, 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.

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 problems of single monetary policy, which can lead to economic divergence among EMU countries, can be tackled by country-specific macro-prudential 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 is questionable 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 on. In this respect, several recommendations are provided in the following:

- The occasions on which a country can receive financial support of the 'fiscal capacity' should be defined conservatively. Normal recessions should be dealt with at the national level by means of automatic stabilisers and existing flexibilities. Only major downswings should be covered by means of a 'rainy day' fund.
- The EMF's fiscal support should not be paid out as a grant, but in the form of an interest-free loan, which would have to be paid back over a longer time period. It is true that a grant would enable better macroeconomic stabilisation properties in case of idiosyncratic shocks. However, it would amount to a transfer and would thus put much more strain on the EMF's resources. Moreover, the degree of risk sharing in the euro area would be substantially increased. Even if the grants are intended to avoid permanent net transfers to individual countries, the question arises as to whether this can be ensured in the longer run. Therefore, interest-free loans should be chosen. Both the financial burden on the EMF and the risk of ending up in a transfer union would be smaller. This option would have the additional advantage of making national fiscal policies more countercyclical because countries would have to repay loans in good times when their fiscal policy tends to be pro-cyclical.
- A decision over the financial resources of the EMF is also needed. The 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 new tool of interest-free loans would eliminate the interest rate margin as a key financing source. Even more financial resources would be needed if EMF support were to come in the form of grants and/or if the EMF was to be provided with sufficient staff to monitor EMU member states. Several options are possible to cover larger financial needs: member states' contributions, delegated own resources like in the EU budget; or even permission for the debt financing of non-crisis-loan spending:
  - Contributions are the preferable option. They keep member states much more involved in controlling the 'fiscal capacity'. Moreover, in order to strengthen automatic stabilisers of national fiscal policy, a direct connection to the national public budgets is useful. This option is also more likely to be achievable on an intergovernmental basis.
  - Delegating own resources would make the EMF less dependent on the member states, but it might be politically challenging to divert a part of EU member states' tax income to an intergovernmental organisation. Moreover, this financing option could imply the danger of a continual enlargement of the 'fiscal capacity' function.
  - The debt financing option for expenditure (apart from loans in the course of an ESM programme) is not recommended. It would require even greater financial resources in order to service and repay the incurred debts. This option could also significantly increase the extent of debt mutualisation.

CONCLUSION

A French-German accord after the elections in France and Germany could lead to greater 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. The first category relates to reinforcing rules and market discipline:

- To strengthen the rules-based EMU framework the EMF could not only replace the IMF in crisis programmes, but could also monitor the implementa-

tion 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 be very likely to include features that raise risk sharing and debt mutualisation – even although 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.
- There may also be proposals to use the EMF as a common fiscal backstop for the Banking Union. However, backing up banking resolutions would imply a large increase in risk taking compared to loans in a normal EMF programme. Thus, the bank-financed Single Resolution Fund (SRF) would have to be required to repay the EMF in due course, as is broadly envisaged already. Moreover, exposure limits for the EMF would be needed in this respect.
- Finally, if a kind of 'fiscal capacity' was established at the EMF, it should become relevant only in deep recessions as a 'rainy day' fund, it should be financed by contributions from EMU countries; and it should not be allowed to raise debt. Stressed countries should only receive interest-free loans with a longer repayment period and no transfers. 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, the creation of an EMF would still be a considerable venture and leaves open important questions:

- 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 over time?

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