FES BRIEFING

REFORMING THE ESM AND AVOIDING A SURGE IN NATIONAL DEBT

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EVERYONE WANTS SURE, NO ONE WANTS THE ESM

The Coronavirus pandemic is leaving a momentous mark on the European economy and thus on the living standards – not to speak of the health – of millions of people. To mitigate these effects, and the associated growth of inequalities and poverty risks, European governments have repeatedly launched financial support measures for the worst-hit people and firms, and on an enormous scale. After some initial hesitation, the European Union has also set to work, coming up with provisions of unprecedented dimensions and characteristics. The SURE (Support to mitigate Unemployment Risk in an Emergency) programme has set aside 100 billion euros in special low interest loans to fund unemployment benefits and other measures put in place by member states to shore up the incomes of the self-employed. Of the 90 billion euros already approved by the Council, 31 billion euros were handed over on 16 November to the ten countries that had applied for it immediately, including Italy, Spain, Poland and Greece.

To fund this, the Commission issued ten- and twenty-year bonds worth 17 billion euros on 21 October. Market demand topped 221 billion euros, more than 13 times the available supply. SURE is thus a financial and political success story. It has demonstrated that: (i) there is considerable appetite for European »safe assets« and thus that shared European debt is not only possible, but also welcome in market terms; (ii) member states are eager to apply for loans from the European Union, within the framework of a programme built on reciprocal trust and shared guarantees. All this would seem to be a good omen for the success of the vast *Recovery and Resilience Facility* (RRF), unless EU budgetary vetoes by Poland, Hungary and (perhaps) Slovenia derail the whole programme.

The European Stability Mechanism (ESM) has not met with similar success. On 9 May 2020 up to 240 billion euros, of the 410 billion euros still available, was set aside for funding directly and indirectly concerned with Covid-19-related prevention and cure, up to a maximum of 2 per cent of each nation's GDP. Despite extremely easy conditions not tied to macroeconomic adjustments (even though this was a requirement of the ESM's founding charter), no European nation has, as yet, applied for the ESM »health« funds. The ESM tool would seem to have become politically »untouchable«.

REINVENTING A TOOL (MISTAKENLY) REGARDED AS TOXIC

Governments willing to resort immediately to the RRF – whose prerequisites are much more stringent than those of the health ESM – are mistaken in their belief that ESM loans are politically toxic, even though their costs are lower than »national« debts. They are wrong but, to be fair, so is everyone else. And this makes it difficult to change their minds. The mistake is due partly to the stigma attached to the very act of resorting to a tool which, it should be remembered, was originally designed to rescue states that had lost access to the market during the sovereign debt crisis. An element in this is fear of what happened to Greece in its struggle against the widely forecast interference of the »troika« (IMF, ECB and European Commission) in its economic policy choices after it applied for assistance, first from the European Financial Stability Fund (EFSF) and then from the ESM. Part of the blame for this is the ESM itself, which is outside the European Union's legal framework – because of UK opposition – and fruit of the intergovernmental logic that prevailed in the wake of the financial crisis. A power of veto was granted to individual member states or, at least, minority blocks. As Lucas Guttenberg, deputy director of the Jacques Delors Centre has written,[1] »the fact that the ESM is seen as a mechanism that is controlled by a handful of member states that will likely never use it is precisely what renders the ESM politically unviable«.

Reform of the ESM, which began long ago but was never completed – partly as a result of the Italian veto on certain clauses that would have made sovereign debt restructuring

1. »Time to come home: If the ESM is to stay relevant, it should be reinvented inside the EU«, 12 November 2020, https://www.delorscentre.eu/en/publications/detail/publication/time-to-come-home.

easier and more automatic – should be completely rethought. I agree with Lucas Guttenberg's view that radical change and complete reinvention of the ESM is required. The latter should be brought fully into the EC's legal framework, changing its name but confirming its sovereign debt restructuring mechanism role and, first and foremost, the Single Resolution Fund backstop so painstakingly set up to deal with banking crises. Bank failure, incidentally, is becoming much more likely precisely as a result of pandemic-related failures. The ESM's capital could be transferred wholesale to the EU as deposit insurance for all the bonds issued by the EU for the purpose of supporting member states in one way or another. A single EU debt agency would thus be created under the Commission's political aegis and European Parliament control with qualified majority Council decisions, like that of SURE. »This would substantially increase the transparency and legitimacy of European economic governance«, but above all it would equip Europe with a complete and coherent crisis management toolbox.

A LONG EMERGENCY AND NATIONAL DEBT EXPLOSION

The issue of finding the resources needed to deal with the immediate health and economic consequences of the pandemic remains, intersecting with the issue of escalating sovereign debt. The IMF is forecasting (2020) that the Euro Area's public debt will increase from 84 per cent of GDP in 2019 to 101 per cent in 2020, with widening nation-to-nation differentials: in Germany the debt/GDP ratio is forecast to increase from 59.5 per cent in 2019 to 73.3 per cent this year, while it Italy the corresponding figures are 135 per cent in 2019 and 162 per cent in 2020. The second wave of the pandemic has, on one hand, postponed economic recovery and, on the other, obliged governments to lay out further considerable sums to cover health expenditure and shore up economies disrupted by new and variegated experiments with partial lockdown. One example are the subsidies payable to winter tourist businesses. Making schools and school buses safe for pupils to ensure school attendance while the virus still presents a danger are further examples. In the absence of targeted measures, the debt/GDP numerator will increase while the denominator decreases. There is thus no chance that the debt/GDP ratio will fall in 2021, despite forecasts to this effect just two months ago. Rather it will increase further in all European countries.

On the other hand, cutting off or reducing subsidies and support today would send GDP into free-fall for an as yet unforeseeable period. This would have an even worse effect on the debt/GDP ratio, to say nothing of the widespread social malaise and poverty it would generate. In either scenario, question marks may reappear over the sovereign debt sustainability of certain Euro Area countries, especially France, Italy, Spain, Portugal and Greece. And a higher debt/GDP ratio for all other European nations – including the more »frugal« – will lead to greater financial vulnerability for the whole continent. This will, in all likelihood, seriously impact recovery and longer-term growth prospects.

FALSE INTER-GENERATIONAL CONFLICT

Sometimes the interests and needs of current generations – today's elderly and adults in general – come to be juxtaposed with those of future generations, generally comprising, together with the as yet unborn, today's young people. It may be argued that emergency spending works to the advantage of today's elderly, and adults in general, at the expense of young people and their offspring, who will be burdened with the debts generated today to pay for spending which will not benefit them. But it is a mistake to cast this in the light of intergenerational conflict, if only because today's young people are themselves fully embroiled in the crisis triggered by the pandemic.

In no way detracting from the importance of investing in rebuilding the social and natural assets to be passed on to future generations, spending today to enable those currently occupying the earth – and thus young people as well – to save themselves and keep afloat means offering them a future that will not be available to those who go under. It thus means giving new generations (the as yet unborn) some possibility of being born into a world free of the debris of the past. Moreover, cancelling all sovereign debts contracted during the pandemic, as some have suggested, would not appear to be an especially astute move as both states and the European Union will be required to source other loans from savers and central banks on the marketplace. But cancelling debts is not the only solution.

RRF RESCUE GRANTS

Overcoming the logic of intergenerational juxtaposition will enable us to think calmly about using part of the grant component made available by the Recovery and Resilience Facility (a total of 312 billion euros) to cover the immediate emergency spending of the various European nations in their efforts to cope with the second wave of the pandemic. In practice, the RRF grants would replace the ESM »health« loans – for which, I repeat, no country has applied – and extend both their scope, with an extra 72 billion euros, and the perimeter of the spending required to make school attendance safe. Naturally, the RRF's loan component should be entirely – and more rigidly – set aside for investment spending, assessing whether it would be opportune to increase its dimensions, in due time, beyond the 360 billion euros agreed in July 2020, given the optimal market reception accorded joint European debt issue.

RRF grants can be rapidly activated, including for subsidies currently being loudly demanded by the winter tourism sector, around a third of whose annual turnover is at risk from the restrictive measures (rightly) being planned for the Christmas period and which may need to be extended. Certainly, coordinated decision-making by EU member states would be opportune. So, too, would an acknowledgement that nations will not all suffer equally from these restrictions and thus, rather than being proportionate to GDP, these subsidies must reflect the (documented) extent of lost turnover. Using grants in this way would enable the accumulation of new national debts in member states to reduce »current« spending and thus make a concrete contribution to the sustainability of these debts, diminishing the likelihood that some nations will need to resort to ESM funding in the future. Young people, and future generations, will naturally be left with the debt agreed by the Commission to fund the RRF. But this is the case however the resources are used. The pandemic is a war. Its negative legacy can be reduced and diluted, but it cannot be eliminated, and it should certainly be shared equitably.

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