

The European Stability Mechanism is a False Solution to a Real European Problem

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The conflict opposing the Northern (and Eastern) to the Southern Member States has reemerged with special animosity in the last weeks. European governments have developed deep disagreements over how to distribute the costs not only of fighting the coronavirus epidemics, but also of the socio-economic reconstruction that would be required once the public health emergence has been overcome, and which will require mobilising resources on a scale unknown since the Second World War.

In particular, the Italian and the Spanish governments have asked for a *common plan* to relaunch the European economy, to which the German and Dutch leaders have vehemently opposed, arguing that the wall of separation between national Treasuries should be preserved. Or what is the same, [coordination of national plans](#) is fine, but not the sharing of the resulting bill.

The March 27th European Council did not result in any progress towards an agreement. However, only twenty four hours after the meeting ended, the daily *El País* published long [verbatim excerpts](#) which were proof of a very tense debate, but in which there were clear inklings that an accommodation between the positions of the parties might be in the process of emerging. According to [the Spanish newspaper](#) “it might be possible to find an agreement between Merkel’s and Sánchez’s views”. An anonymous diplomat was quoted saying that it might be possible to “reinterpret the rules governing the European Stability Mechanism [ESM] with a view to adapting them to a crisis that is not fiscal but conjunctural”. A view echoed by the ESM Chairman [Klaus Regling](#), and reflecting the proposal made by the Italian Prime Minister Giuseppe Conte on [his interview](#) to *Financial Times* on March 19th, namely, to achieve the objectives of Southern European countries (sharing the costs of restarting European economies) through the means preferred by Northern Member States (the ESM).

It seems to us, however, that such a “compromise” would hide an outcome contrary not only to the Italian and Spanish national interest, but also to the European common interest. To realise why this is so, it is necessary to be fully aware of what the ESM is, and what is the legal framework within which it operates. It seems to us that the following four observations should be made.

1.

The legal basis of the ESM is to be found in Article 136.3 of the Treaty on the Functioning of the European Union. It is important to keep in mind that not only

the ESM was created outside the scope of application of European Union law (something which at the very least weakens the force of the mandate of solidarity between Member States as enshrined in Article 222 TFEU) but also that the financial assistance to be provided through this vehicle is to be granted subject to “strict conditionality”. In plain English, the latter means that money will only be forthcoming after the debtor state has transferred the power to decide its national economic policy to creditors, in the framework of the notorious Memoranda of Understanding (far too well-known in Greece, Ireland or Portugal).

The deal is: some (but not much) money in exchange of fiscal sovereignty. Because the Treaties require *strict* conditionality, “soft” or “weak” conditions, as it seems pretend the Italian and the Spanish governments, would only be [possible if and after the Treaty on the Functioning of the European Union \(and the Treaty establishing the ESM\) were amended](#). Not exactly an easy walk, certainly not something that can be achieved in a short period of time. To ignore that Article 136.3 requires conditionality to be strict may lead to a rude awakening, as our colleague [Alessandro Mangia](#) has reminded us. Any government may raise the issue before the European Court of Justice. It might be self-deluding to expect the Luxembourg judges not only to ignore the literal tenor of the referred Treaty, but also their own case law, in which strict conditionality has become a meta-principle of European law (see their ruling on [Pringle](#), especially paragraph 137).

2.

Even if a magic formula would be found to avoid the hurdle of Article 136.3 TFEU (for example, Member States would agree to construct “strict” in the phrase “strict conditionality” as merely requiring that the funds would be spent in fighting the coronavirus and in later reconstruction understood quite widely), it needs to be observed that the conditions to which the granting of an ESM loan may not only be changed at a later stage (as foreseen in Article 7.5 of Regulation 472/2013 of the European Union), but also that the fact that the “assistance” is provided in installments entails that creditors have not only the legal, but also the economic power to eventually alter the terms of the agreement every six months for as long as money is forthcoming. To put it differently, for a “condition-less” ESM loan to be possible, it would be necessary to persuade not only Mark Rutte and Angela Merkel, but also their future successors of the wisdom of such choice.

Is that realistic? Some might argue that it is likely that the position of Northern (and Eastern) executives will radically change when the coronavirus pandemics hit such countries with full force in a matter of weeks, if not days. However, it is far from obvious that deep-seated attitudes towards economic redistribution across borders would be radically transformed overnight, not even if such predictions would come true. Moreover, it is not impossible that the impact of the coronavirus might remain very different across Europe, in which case it is perhaps even more likely that an initial “soft” conditioning might be followed by a return to “hard” conditioning. In that regard, one should keep in mind how short-lived was the 2008 consensus on the need of a Keynesian reflation of the world economy, and how suddenly it was replaced by an obsession with the (counterproductive) reduction of public expenditure.

3.

The ESM is likely to impose upon states taking loans to subject their debt to [Luxembourgish law](#), therefore renouncing the application of their own law. This is not a mere technical issue, but one with deep political implications. The point of such a move is to prevent the debtor state from making use of its sovereign power to alter the conditions of repayment of the debt. As a result, taking loans from the ESM results in a radical weakening of the capacity of the debtor state to recover its monetary sovereignty. Were it to try to do so, it could not redenominate the debt, and would thus remain obliged to paying it in what would be now a heavily revalued foreign currency.

Let us be clear in this regard. We are not necessarily saying that Italexit or Spanexit are tempting choices under the present circumstances (in which not only social cohesion, but even public order is severely tested). What we are [reminding the reader](#) is that the perspective of exit remains the only serious bargaining chip left in the hands of the Member States of the Eurozone periphery (as no other than [Wolfgang Münchau](#) pointed last week). Becoming indebted to the ESM is almost tantamount to rendering exit extremely difficult, and consequently, undermining the effect of eventually threatening with exit from the Eurozone, even if one coordinated with other Eurozone partners.

4.

In the present context, ESM loans are mere means to achieve a more fundamental end, namely, an (almost) unlimited support from the European Central Bank, as an (indirect) buyer of last resort of the public debt issued by Southern European States. This is so because the ESM does not have sufficient “firepower”. Its lending capacity is actually limited to 440 bn euro. That is a lot, but not enough to refinance the debt of Italy and Spain (even less of the Eurozone as a whole).

This is where the ECB comes into the picture, equipped as it is after Draghi’s “whatever it takes” with a potentially unlimited capacity to buy public debt. The so-called OMT programme foresees that, provided a state has a running programme with the ESM, the ECB might buy potentially unlimited amounts of its public debt (despite the literal tenor of Article 123.1 TFEU). From such a perspective, a “condition-less” ESM is necessary not so much for the sake of getting access to the funds of the ESM, but as the key that opens the door to the ECB’s vault, so to speak.

This line of reasoning too is, however, flawed. It does not consider that the very *constitutionality and legality* of the OMT programme was said to depend on the fact that the ESM imposed strict conditionality on the borrowing state, a strict conditionality which would then be *reinforced* by the ECB.

It should be kept in mind that Draghi’s *whatever it takes* was highly controversial, and indeed led to a [judicial saga](#) involving the German Constitutional Court and the European Court of Justice, in which an open conflict was only avoided precisely thanks to the ECJ’s emphasizing the key role of strict conditionality in the operations of the ECB.

A “decaffeinated” ESM might risk reopening a door that in fact has only be left ajar (the publication of the ruling of the German Constitutional Court on the ECB’s *quantitative easing programmes*, planned for March 24th, has been postponed to May 5th). Moreover, it has to be kept in mind that the actual buyers of public debt are *national* central banks, so doubts over the (German) constitutionality of debt buying in the absence of strict conditionality might lead to the Bundesbank opting out from the scheme, and consequently, its unravelling.

On such a basis, it has to be concluded that a condition-less or conditionality lite ESM loan is (1) impossible according to the European Treaties in force; (2) even if conditionality would be “light touch” in the short run, it could be hardened in the long run; (3) becoming indebted to the EMS renders exit from the Eurozone close to unfeasible, and consequently, weakens the bargaining position of the states of the Eurozone periphery; (4) the financial firepower of the EMS could not fund post-coronavirus reconstruction, so it will be necessary to have resort to the ECB, which in turn can only buy public debt in secondary markets if that reinforces, not weakens, strict conditionality.

Does this mean that we are condemned to some form of nostalgic pessimism? Not in our view. But what is needed is a form of realism not even tempted by naïve Europeanism.

In the short run, Southern states should push for massive debt buying on the side of the European Central Bank. True, Christine Lagarde’s [gaffe](#) on March 13th was of epic proportions. By the same token, it is important to keep in mind that the measures taken by the ECB five days later (the so-called [Pandemic Emergency Purchase Programme](#)), contrary to what quite a number of commentators and pundits have taken for granted, [benefit disproportionately German and French banks](#). *Eppur si muove*. On March 25th, the ECB lifted the ceilings on the ratios of public debt it can buy under its new quantitative easing programme, so it can now intervene in an asymmetric fashion. The means are in place to buy time (even if there are risks involved, because the debt the ECB buys is very short term one).

Once the emergency is besides us, it will be time to decide, in a reflective and unprejudiced way, whether the conditions are met for a radical change in the way European Economic and Monetary Union is understood; in other terms, if there is the political and social will to move from a union based on debt to one grounded on mutual credit. If that would not be the case, it would be the time to draw all necessary even if painful conclusions. The status quo is simply impossible, not only in economic terms, but also in democratic ones. The European Union has run out of easy short cuts.

An Italian version of this article has previously been published on [Lacostituzione.info](#), and a Spanish one on [CTXT](#).

