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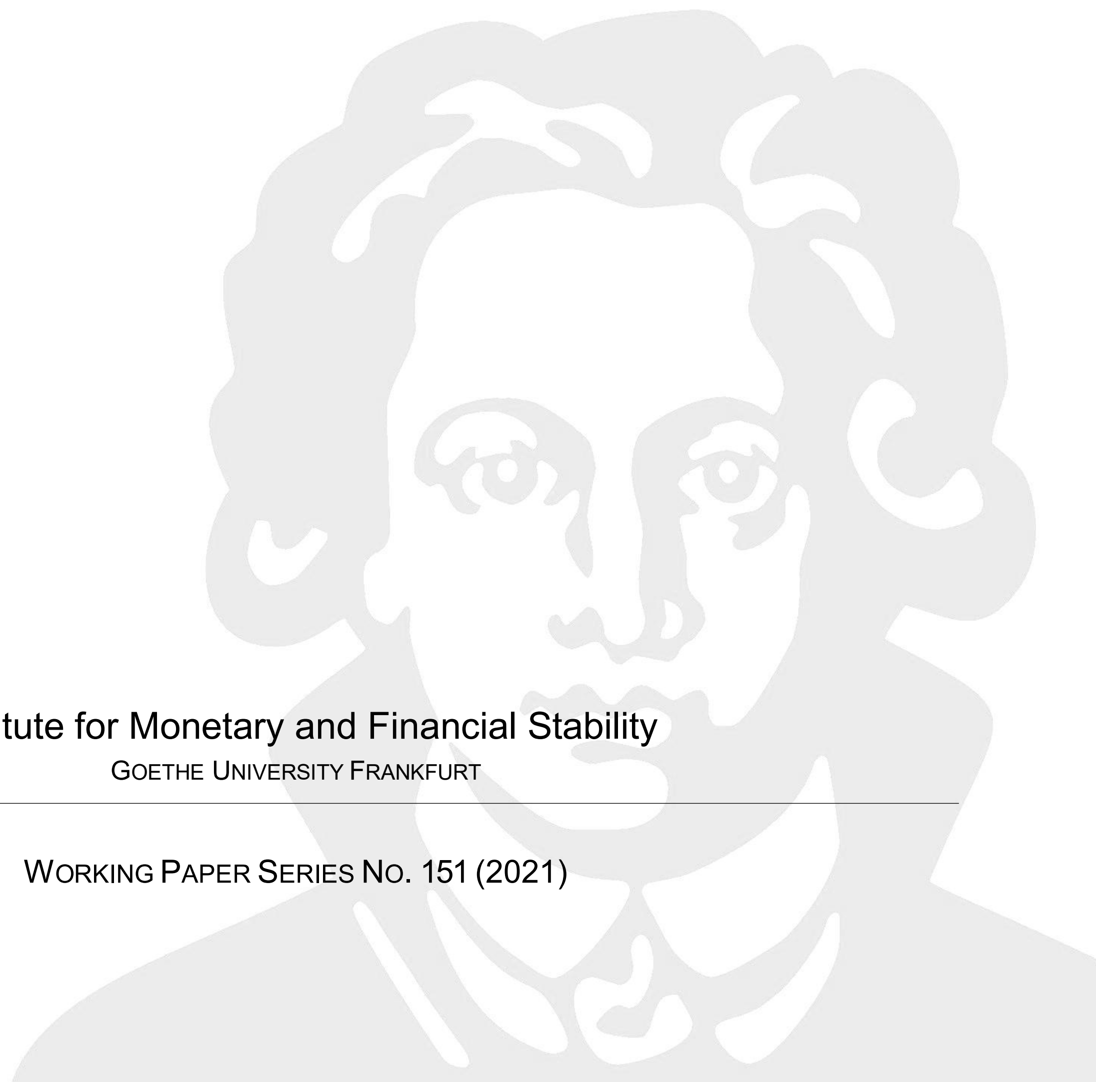

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Designing a European Monetary Fund: What role for the IMF?

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Abstract:

The so-called Troika, consisting of the EU-Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF), was supposed to support the member states of the euro area which had been hit hard by a sovereign debt crisis. For that purpose, economic adjustment programs were drafted and monitored in order to prevent the break-up of the euro area and sovereign defaults. The cooperation of these institutions, which was born out of necessity, has been partly successful, but has also created persistent problems. With the further increase of public debt, especially in France and Italy, the danger of a renewed crisis in the euro area was growing. The European Stability Mechanism (ESM) together with the (strongly politicized) European Commission will replace the Troika in the future, following decisions of the EU Summit of December 2018. It shall play the role of a European Monetary Fund in the event of a crisis. The IMF, on the other side, will no longer play an active role in solving sovereign debt crises in the euro area. The current course is, however, inadequate to tackle the core problems of the euro zone and to avoid future crises, which are mainly structural in nature and due to escalating public debt and lack of international competitiveness of some member countries. The current Corona crisis will aggravate the institutional problems. It has led to a common European fiscal response ("Next Generation EU"). This rescue and recovery program will not be financed by ESM resources and will not be monitored by the ESM. One important novelty of this package is that it involves the issuance of substantial common European debt.

1. Introduction

Despite the no-bailout clause of the Treaty on European Union, the EU countries decided in May 2010 to save Greece from state bankruptcy by granting high loan commitments. The International Monetary Fund (IMF) contributed to the financing of the aid. Together with the European Commission (EU Commission) and the European Central Bank (ECB) the IMF developed and monitored the economic adjustment program for Greece. The so-called Troika was born. In the further course of the sovereign debt crisis in the euro area, in which Ireland, Portugal, Spain and Cyprus also had to apply for bailout programs, the European Stability Mechanism (ESM) became the fourth institution, and the Troika transformed to a "Quadriga".

The involvement of the IMF in the rescue programs was controversial from the start. The ECB's participation raised critical questions regarding the separation of monetary policy from fiscal and economic policy. The EU Commission had a strong political influence on the reform programs and their conditionality, which was partly contrary to the goals of the donors. This ad hoc solution was taken (1) as the crisis rapidly spread in the countries concerned and on EU financial markets and (2) as there was a growing danger that individual countries have to leave the euro area or that the whole euro area could even collapse. A European Monetary Fund did not exist, an institution which (like the IMF worldwide) is solely responsible for financing and negotiating with countries in the event of a balance of payments or sovereign debt crisis.

Now that the rescue programs with all affected countries are completed and as a return to the no-bailout clause appears politically unrealistic, the question arises which institution with which legal and substantive orientation could combat a sovereign debt crisis in the euro area in the future. Leading EU politicians, such as French President Macron, have called for the further development of the ESM into a European Monetary Fund (EMF). The EU Commission presented such a comprehensive concept in December 2017. Decisions on the future tasks of the ESM were made at the Euro summit in December 2018. They lagged far behind the ideas of the EU Commission. Is the agreed course a step in the right direction? And how should a European Monetary Fund ideally look like in the light of the experience from the past crisis - regardless of the often very different political views of the individual member states? What rights and tasks should an EMF or an ESM have so that it can act quickly, but also efficiently and sustainably in the event of a future crisis? How should its scope of action be limited so that it does not generate a new sovereign debt crisis in individual countries through moral

hazard behavior? How does the Corona crisis affect this process? These are questions we want to address in what follows.

The Corona-crisis and the rescue packages of the EU, its member states and the ECB are not the subject of the present paper. They are financed by the EU without the need of a reform program and monitoring. However, the measures undertaken have repercussions on the future working of the ESM (and a potential EMF). Moreover, the deep recession in several, mostly southern European economies, will aggravate the public debt problems. Their solution will necessitate the involvement of the ESM in some form.

The paper is structured as follows: Chapters 2 and 3 describe in more detail the role of the institutions in the Troika or Quadriga, respectively. Against the background of an optimally structured EMF, chapter 4 discusses the institutional and practical problems of such a Fund. Chapter 5 briefly analyzes the repercussions of Covid-19 on the topic. Chapter 6 summarizes and concludes.

2. The role of Troika members in the rescue programs

2.1. The International Monetary Fund (IMF)

The IMF played a key role in the sovereign debt crisis in the euro area and in the bailout programs for Greece, Ireland, Portugal and Cyprus.[1] The IMF participated in the first three bailout programs for Greece (starting in May 2010), Ireland (December 2010) and Portugal (May 2011) with funding of around 30 % of the total aid loans (see Table 1). The remaining funds were granted as bilateral loans from EU member states, the European Financial Stabilization Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM). The IMF was not the main donor of the Troika, consisting of the EU Commission, the ECB and the IMF. However, due to its more than 70 years of experience in solving international balance of payments and debt crises, the IMF was central to the development and ongoing monitoring of the adjustment programs with the debtor countries. Although the IMF had already put in place adjustment programs with grants for Hungary and Latvia in 2008 and for Romania in 2009 together with the European Union (Jost & Seitz 2012, p. 2), the IMF's involvement in the rescue operations for member countries of the euro area was unprecedented in size and

[1] The IMF did not participate in the funds that the Eurogroup raised for Spain for the re-capitalization of its banking system. The Spanish program was not a full program, like in the case of the other countries. The IMF's role was limited to advice and surveillance.

problems and conflicts that followed. In addition to the expected conflicts with the debtor countries, particularly in the case of Greece, different objectives of the IMF and the other institutions involved made the effective resolution of the crises difficult.

Table 1: Rescue programs for selected economies and IMF involvement

	Greece 1	**Greece 2**	**Greece 3**
Program	SBA – 3 years	EFF – 3 years	EFF – 3 years
Start	May 9, 2010	March 15, 2012	August 2015
IMF contribution	Euro 30 billion	Euro 28 billion	No contribution
in % of country quota	3,212	2,159	
Contribution of European partners	Euro 80 billion	Euro 145 billion	Euro 86 billion (ESM)
	Ireland	**Portugal**	**Cyprus**
Program	EFF – 3 years	EFF – 3 years	EFF – 3 years
Start	December 16, 2010	May 20, 2011	May 15, 2013
IMF contribution	Euro 22.5 billion	Euro 26 billion	Euro 1 billion
in % of country quota	2,322	2,306	563
Contribution of European partners	Euro 45 billion	Euro 52 billion	Euro 9 billion

Note: SBA = Standby Agreement, EFF = Extended Fund Facility.
Source IEO (2016), p. 1; Mink (2018), p. 253.

When Greece's budget and debt problems worsened in early 2010 to such an extent that financial aid seemed inevitable to avert bankruptcy, many economists, politicians and the ECB ruled out IMF participation in a bailout program for Greece. For example, the then ECB President Trichet refused aid from the IMF by referring to European financial aid for balance of payments problems and the deficit rules of the Stability and Growth Pact (Jost & Seitz 2012, p. 9). The then Bundesbank President Weber said in an interview on December 9, 2009, that "within the stability and growth pact there is no role for the IMF" (Brunnermeier et al. 2016, p. 297). A few days earlier, the Greek finance minister stressed that IMF participation was out of the question, referring to French President Sarkozy, who never wanted the IMF to operate in Europe (Brunnermeier et al. 2016, p. 297). At the same time, the idea of a European Monetary Fund came up for the first time. In March 2010, the then German finance minister Schäuble proposed to create a European Monetary Fund. He found it difficult to involve the IMF in the euro area where member states have lost a central national policy instrument,

monetary policy. He advocated a European Monetary Fund with strict conditions (Schäuble 2010). On the economist's side, Daniel Gros and Thomas Mayer were the first to suggest a European Monetary Fund (Gros & Mayer 2010).

However, there were also voices urging involvement of the IMF, particularly as the participating European institutions lacked the expertise and credibility to set up and monitor economic adjustment programs. In its more than 70-year history, the IMF had launched a multitude of conditionality bailout programs for many of its member countries and in most cases successfully completed them. The EU Commission, which had been responsible for monitoring the rules of the European Stability and Growth Pact since the beginning of the Economic and Monetary Union, was unable to establish credibility due to its non-action in spite of the many violations and failures to comply with the rules to limit budget deficits. It also lacked the technical expertise in drawing up and monitoring economic reform programs. The role of the ECB in the euro sovereign debt crisis had been viewed very critically by economists from the outset, as it cannot be responsible for overseeing, reforming and monitoring national financial and economic policies, and it also lacked the necessary expertise.

The expectation was that, in contrast to the EU Commission, the involvement of the IMF in designing and monitoring adjustment programs would be more neutral and less politicized. Although the IMF is also influenced by political interests, and above all by the political ideas of its main lenders, it has a broader membership structure and lacks proximity to the EU and its institutions. In summary, due to its greater independence from politics and its reputation as a crisis manager the involvement of the IMF should have significantly increased the credibility of the support programs, among other things due to tougher requirements for the reform countries (Jost & Seitz 2012), p. 9).[2]

According to the Independent Evaluation Office (IEO) of the IMF, the German government under Chancellor Merkel and some other European governments were the driving forces behind the IMF's rescue policy for Greece. But other countries, especially France, were against it.[3] In the following years, the German government insisted that the IMF should be closely

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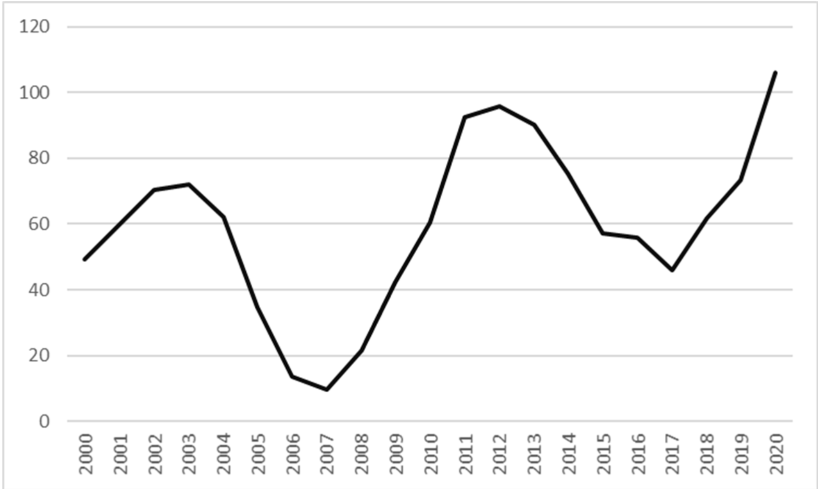
[2] Gupta et al. (2018) show that the implementation of structural conditionality is essential for the long-term benefits of IMF programs. And Krahnke (2020) established that the catalytic function of the IMF to raise additional private funds is only existent if certain thresholds of IMF programs are not exceeded.

[3] See Kincaid (2017), p. 148. The IEO interviewed high-ranking officials of the euro area about this question.

involved. Even when the IMF did not provide funding for the third aid program for Greece, the German government continued to urge for an involvement of the IMF in drawing up and monitoring the program.

However, the IMF had no clear and elaborated concept for a sovereign debt and financial crisis in more advanced member countries of a monetary union. In the past, many IMF reform programs have been successful when combined with a depreciation of the national currency and monetary policy measures. The IMF treats each country as a sovereign state and calls for reforms in many policy areas that are under the country's control. In contrast, in a monetary union, only a limited policy area can be tackled by the IMF, which means that not all of a country's economic problems can be effectively addressed (Nelson 2017), p. 9). Since the European officials excluded a country's exit from the currency union for fear of collapse of the whole system, the policy instruments of national monetary and exchange rate policy were not available. Thus, for example, a (temporary) exit of Greece from the monetary union with the aim of a devaluation to (re-)establish international price competitiveness quickly, as Sinn (2015, p. 480ff.) suggested, was not possible. The IMF broke new ground and took big risk. It moved from a Fund to tackle short-term balance of payments problems to a Fund to solve long-term structural problems. This might be one reason why the IMF tried to withdraw more and more from being an active part in the Troika.

Figure 1: Outstanding IMF loans (SDR billion)



Note: IMF (2021).

Internally, the IMF's entry into the Troika represented an opportunity for the management of the IMF. The IMF had lost much of its importance in the years before the global financial and economic crisis. Outstanding loans from the IMF reached a low in 2007 (see Figure 1). Since

the IMF is financed to a considerable extent by the interest income from its loans, it had to reduce staff during this period. After the Asian crisis in the late 1990s, the number of regional financing agreements (RFAs) increased as countries tried to become more independent of the IMF and its economic reform requirements and funding conditionality that were often perceived as hard and anti-social.[4] Moreover, Strauss-Kahn, the then French IMF director, was interested in involving the IMF in combating the crisis in the euro area in order to be at the center of discussions in the global economy (Brunnermeier et al. 2016, p. 298). The US were also interested in involving the IMF, especially in Greece, for geopolitical reasons (Sinn 2015, p. 366).

With the participation in the first bailout program in May 2010, the IMF began in many ways a balancing act that lasted for several years. In some cases, this engagement brought the IMF significantly beyond the limits of its guidelines for lending. The IMF's financial contribution to the first Greece program corresponded to 3,200 percent of the country's IMF quota, making it the largest support program in the history of the IMF (in terms of quota). A loan should normally reach a maximum of 600% of the quota (Nelson 2017, p. 4). Consequently, the IMF loan portfolio became highly concentrated in Europe (Reinhart & Trebesch 2015, p. 23f).

The IMF Executive Board in Washington decides whether to accept an aid program or not. According to past experience of the IMF and the standards it has set, a program should only be adopted if there is both a high probability of repayment and a high probability that a country's outstanding debt will be sustainable in the long term (debt sustainability) (IMF 2017). In the case of Greece, there were considerable doubts about both aspects from the start. Therefore, these conditions were circumvented by introducing a new clause, the systemic exemption, which referred to the risk of contagion (systemic risk) within the euro area (Brunnermeier et al. 2016, p. 298; Nelson 2017, p. 6). The program for Greece therefore included no haircut and no involvement of the private sector.

All these problems were discussed controversially in the Executive Board and in IMF member countries outside the euro area. However, the Executive Board was "overrun" by the events and decisions of the European partners in the days leading up to the decision on the program.

[4] See Nelson (2017), p. 6. RFAs are for example the Arab Monetary Fund, the BRICS Contingent Reserve Arrangement, the Chiang-Mai Initiative, the Eurasian Fund for Stabilization and Development, the Latin American Reserve Fund.

As the Eurogroup and the EU Commission had given a positive vote on the program they had drawn up and made the results public, the IMF was under pressure. Finally, the Executive Board had to agree without intensive discussion of its own program developed in parallel to the Commission program (De las Casas 2017, p. 16f).

The “Independent Evaluation Office of the IMF” (IE0) complained that political pressure from outside limited the technical assessment of the IMF staff and the political decisions of the IMF in the Troika (IEO 2017, p. 5). From the outset, the excluded debt restructuring for Greece by European public sector donors reduced the instruments normally available to the IMF to combat a debt crisis (Nelson 2017, p. 5).

In the period leading up to the third aid package for Greece in August 2015 there was a controversial discussion about the unresolved problems of Greece (questions of debt sustainability, restructuring and partial haircut, involvement of the private sector). During the whole process, the IMF and the other Troika members judged debt sustainability of Greece differently. For the German government, a general haircut for Greece has been infeasible. The ECB has always objected any form of debt restructuring (Brunnermeier et al. 2016, p. 299). The debt relief that came about in March 2012 and in which private creditors lost claims amounting to EUR 105 billion, was decidedly rejected by ECB President Trichet. The initiative originated from an agreement between German Chancellor Merkel and French President Sarkozy in summer 2010. The ECB president was convinced that government debt must be safe, otherwise it could cause severe financial market tensions. He saw this as endangered when, in spring 2012, government bond yields rose significantly in some euro area countries (particularly Italy and Spain). The ESM, which later joined the Troika as the fourth institution and as a permanent financing mechanism for European countries, categorically rejected a haircut until the end, even though it initiated a de facto haircut by lowering interest rates and extreme maturity extensions (see chapter 3).

Another problem referred to the conditions of the adjustment programs for the crisis countries. The IMF developed its approach through a multitude of crises, which primarily relies on structural reforms to achieve more competition and efficiency. Its goals were not always in line with those of the EU Commission and the ECB. As noted earlier, IMF programs often worked via a devaluation of the domestic currency (in addition to a haircut). In a monetary union, the restoration of international price competitiveness requires an internal devaluation

through wage and price cuts that are difficult to enforce in countries with strong labor unions. In Greece, there was strong resistance of parts of the population and public institutions that delayed the implementation of important adjustment steps (in labor as well as goods markets). The IMF has shaped the notion that the population must support economic reforms in order to be successful. Greece, however, proved to be the IMF's most difficult negotiating partner in its more than 70 years of history.[5] There were protests and headwinds in Ireland and Portugal, too, but significantly less than in Greece. All this damaged the IMF’s reputation. Most visibly, the Greek default on IMF loans in mid-2015 was a blow to the IMF’s seniority status (Reinhart & Trebesch 2015, p. 24f). This episode illustrates how dangerous it is for a lender of last resort, like the IMF, to agree to serial lending to a country with unsustainable public debt. This was enabled through the already mentioned "systemic exemption" clause (IMF 2014; Reinhart & Trebesch 2015, p. 26f).

With respect to the required economic reforms, the IMF was not necessarily the toughest institution within the Troika, especially after the implementation of the first programs. In some cases, the EU Commission and ECB representatives were stricter in their demands against the debtor countries. However, the IMF's main mistake was probably the false assessment of the negative effects of public expenditure cuts and tax increases that it enforced in the crisis countries as well as the wrong assessment of debt sustainability. IMF officials later admitted these errors when estimating fiscal multipliers (IMF 2013). After the programs were completed (the last Greece program in autumn 2018), there were signs that the IMF would withdraw from possible future support programs for member states of the euro area. Christine Lagarde, the then managing director of the IMF, admitted in an interview that the call for a European Monetary Fund is not a problem for the IMF (The Telegraph 2018).

As a preliminary conclusion, one can state that the IMF should no longer co-finance a reform program in a new debt crisis and it should not develop an economic adjustment program for euro area members.[6] The IMF's budget is limited and it cannot save the whole euro area in a crisis spreading to the bigger euro area countries, just as IMF programs are practically

[5] Christine Lagarde who favoured a rescue of Greece by the IMF and European institutions, stated in different interviews that Greece contributed substantially to the difficulties. Especially, she criticized the high rate of tax evasion in Greece (The Guardian 2012).

[6] This might be problematic against the background that global financial crises and international interconnectedness have more and more a significant impact on the probability that a member country obtains financial assistance from the IMF (Poulain & Reynaud 2017).

unthinkable for the US or Japan. The IMF should focus on crisis prevention and financial aid to developing and emerging countries.[7] Only one single, independent European institution can guarantee clear responsibility and a coherent economic adjustment program for countries in the euro area - and not a Troika or Quadriga. However, the IMF can play a role as an independent advisor in the form of technical expert assistance.

2.2. The European Central Bank (ECB)

The ECB, under its then President Trichet, who had international experience in negotiations with debtor countries and the design of economic adjustment programs due to his previous work as President of the Paris Club, participated from the start in the first program for Greece. The ECB thus became a member of the Troika. Unlike the IMF and the other European institutions, the ECB made no financial contribution to the programs.[8] It also did not prepare an own adjustment program for the crisis countries, as the IMF and the EU Commission did. The ECB's task was to provide technical assistance and advice on the preparation of the programs. ECB experts should provide support particularly on questions of the stability of the financial system in the euro area and the monetary effects of the programs. The precise influence and role of the ECB and its staff in the Troika teams remained ambiguous, as the ECB has not published any information on this issue. However, anecdotic evidence indicates that ECB staff also developed proposals and influenced the fiscal programs and the structural reforms required by the countries (Gros 2015, p. 2 f.; Pisany-Ferry et al. 2012, p. 24f). The highest body responsible for the decisions of the ECB in the Troika was its 6-member Executive Board and not the Governing Council, which was politically and legally problematic.

The participation of the ECB in the Troika raised the question of whether this would not violate its mandate if it imposed fiscal and structural reform requirements on individual countries in the euro area and monitored these by participating in the Troika missions. The ECB's political mandate is primarily limited to safeguard price stability in the euro area as a whole. In a crisis,

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[7] In their review of 70 years of IMF history, Reinhart & Trebesch (2015) emphasize that the post-2008 increase in the volume of IMF lending to advanced economies was similar to the patterns seen in the 1950s and 1960s. Their analysis also reveals that the heavy use of IMF lending by so many countries is clearly not due to short-term currency crises and banking crises. Instead, IMF lending programs increasingly occur in countries facing problems with insolvency of sovereign and sometimes private debt.

[8] The EU Treaty does not allow direct government financing through the ECB.

the tasks of the ECB can be expanded to maintaining the stability of the financial system across the euro area, but not to fiscal and general economic policies of the individual member states.

The dilemma for the ECB was even more pronounced with respect to monetary policy measures it took at the time the first program for Greece started. As the yields on government bonds in the crisis countries rose sharply, the ECB began to buy government bonds of these countries on the secondary market as part of its Securities Markets Program (for around euro 210 billion until the program was finished in September 2012). The ECB justified this measure with a "disruption of the monetary transmission mechanism", as its policy of monetary easing did not lead to an equal reduction of interest rates in all euro area member states. In the following years, the ECB pursued an extremely expansionary monetary policy. It lowered its key interest rate to zero, introduced even negative rates on its deposit facility, provided banks with virtually unlimited reserves and allowed national central banks in the euro area via Emergency Liquidity Assistance (ELA) and the Agreement on Net Financial Assets (ANFA) to create central bank money nationally at their own risk. Finally, the ECB purchased around 2.6 trillion euros in government bonds and other securities under the quantitative easing (QE) program (from spring 2015 until end of 2018). The ECB always emphasized that it acted within its mandate and these measures were purely in terms of monetary policy. Especially, the ECB argued that there was a risk of deflation. Since 2017, as the fear of deflation was no longer justified, the ECB changed its wording arguing that the inflation rate is too low, compared to the target inflation rate of below, but close to 2%. In fact, and as with the SMP program, QE, above all in the form of the Public Sector Purchase Program (PSPP), actually contributed to the easing of financing conditions for the crisis countries (e. g., Priftis & Vogel 2017).

It seems that due to the high risk the ECB was taking and the associated loss of public image and credibility, the ECB attempted to influence the economic and budgetary policies of individual euro area countries. During the SMP program, the ECB President sent letters to the governments of Spain and Italy demanding reforms in return for the ECB's bond purchases. The ECB did not publish these letters, but they were leaked to the press. They can be interpreted as conditions (conditionality) of the ECB for its lender-of-last-resort function vis-à-vis crisis countries in the euro area (Gros 2015, p. 1; Brunnermeier et al. 2016, p. 333 ff.; Pisani-Ferrry et al. 2012, p. 25).

These considerations imply that the ECB should withdraw from its role as a full Troika member. The ECB's narrow mandate does not allow to impose fiscal and structural adjustment programs on sovereign countries. Rather, it could damage its reputation and independence. However, the ECB could give advice in matters of the stability of the financial system and of sovereign debt sustainability. As the institution responsible for the supervision of systemically important banks in the euro area (pillar 1 of the Banking Union), the ECB needs information about the banks and the interconnectedness of the banking sector with the national governments in terms of public debt.

2.3. The European Commission

The European Commission was the third Troika member. The EU Commission was not a donor like the IMF. As described above, financial aid came from individual EU countries and several funds of the euro countries (via the institutions EFSM, EFSF and from 2012 onwards the ESM). The Eurogroup of Finance Ministers representing the national governments had to decide on the volume of financial aid and the related economic adjustment programs. The Eurogroup delegated the task of developing and monitoring the programs to the EU Commission in cooperation with the ECB and the IMF. EU Commission staff was therefore part of the Troika teams who negotiated the programs with the governments of the debtor countries and monitored them on a quarterly basis. Like the IMF, the EU Commission has published extensive documents on the economic adjustment programs which document the reform requirements (conditionality) and their implementation.[9]

At the beginning of the program negotiations, the EU Commission, like the ECB, had no experience in developing, managing and implementing economic reform programs in debtor countries. However, since the Stability and Growth Pact came into force in 1996, the EU Commission has been responsible for monitoring the fiscal policies of EU member states. In complex procedures, the EU Treaty requires to urge member states to follow sound budgetary policies and to determine whether the fiscal criteria for annual public deficits and sovereign debt levels have been broken. In these cases, the Commission had to initiate the need for correction and, in extreme cases, to impose sanctions. However, due to the politicization of

[9] The documents and reports are published on the IMF and EU Commission websites. The ECB has not published reports on the reform programs.

the procedures and the dominance of discretionary measures without any automatism, the EU Commission acted as a "lame duck" in this process.

Table 2: Number of failures to meet the public deficit criteria of a maximum of 3% in relation to GDP (1999-2015)

France	11
Portugal	10
Greece	10
Italy	8
Ireland	5
Germany	5
Spain	4

Source: CESifo (2016).

Calculations by CESifo show that, from 1999 until 2015, 165 violations of the 3% limit of the annual budget deficit occurred, mostly in France, Portugal, Greece and Italy (see Table 2). In 112 cases, the EU Commission should have imposed sanctions, but this never happened (CESifo 2016). The Commission's lack in successfully monitoring and controlling public deficits contributed to Greece, Portugal and later Italy being dragged into the debt crisis. These countries had not been able to reduce their public deficits since they entered the Monetary Union. Instead, their deficits rose despite favorable economic conditions in the first years of EMU. Spain and Ireland, on the other hand, revealed a sound public finance behavior in the early years of Monetary Union.

Due to this failure, there was a fear that the EU Commission could have a soft stance towards the debtor countries regarding the reform requirements and the goal of reducing public debt levels by increasing government revenues and (preferably) reducing government expenditures. According to anecdotal reports, the working climate between staff members of the three institutions was positive and it is not documented that one of the institutions played the role of a "tough guy or a soft guy" compared to the others. However, as already described, there were sometimes very different objectives of the IMF on the one hand and the European institutions on the other.

The role of the EU Commission in the Troika was difficult due to the politicization of the whole process. ESM decisions on grants normally require unanimity of finance ministers on the ESM Board of Governors. In addition, national governments and – in some member states national

parliaments – have to agree. With so many participants the whole process is subject to constant renegotiations, which made the Commission's task extremely difficult. In addition, the EU Commission was meant to enforce rules agreed at the EU level. However, these rules often did not correspond to the details of the conditions of the reform programs. The Commission acted as an agent of the Eurogroup, which led to conflicts. For example, the EU's fiscal rules were eased in the reform programs for Greece, Portugal and Ireland. One of the tasks of the EU Commission is to prevent prohibited state aid for banks, but the reform programs had to be implemented in such a way as to keep the banking system alive in the crisis countries (Pisany-Ferry et al. 2013, p. 109 f).

The EU implemented many reforms in the course of the crises. They aimed to make individual economies more crisis-proof through macroeconomic surveillance and the introduction of new procedures, institutions and rules. The EU established a banking union to make the financial system more stable and less vulnerable. In addition, it tightened the rules of the Stability and Growth Pact (SGP), adopted the fiscal compact and introduced a macroeconomic surveillance process. The EU Commission monitors these rules, makes recommendations and, if necessary, introduces sanctions. If a crisis occurs, the ESM can grant emergency loans. However, the monitoring and enforcement of the rules of the fiscal compact and the SGP is also not credible due to individual countries' violations and increasing political resistance from euro area governments to "requirements from Brussels". The increased macroeconomic surveillance is very complex, its details are controversial and only binding to a very limited extent.

There was also a conflict between the EU Commission and the ESM regarding the future interaction in the design and monitoring of economic adjustment programs. The Commission, which has seen itself even more as a political Commission since Jean-Claude Juncker's term as president, strives to play a leading role in a possible institutional team with a future EMF. The EMF should finance the program whereas the Commission will act as the senior partner in the process of negotiation, adoption and monitoring of the reform programs. However, it would make more sense to limit the role of the politically dependent Commission as far as possible.

3. The fourth institution: The European Stability Mechanism (ESM)

The ESM was established in October 2012 and replaced the EFSM and the EFSF as a permanent rescue fund for euro area countries in crisis that are no longer able to finance their sovereign

debt on the market. The ESM is an intergovernmental financial institution that is not part of the EU Treaties. The Board of Governors of the ESM decides unanimously on the granting of aid and the necessary reform requirements for the debtor countries. Its members are the finance ministers of the euro area countries.[10] The Board of Governors thus corresponds to the informal Eurogroup. In case the public debt problems of individual countries endanger the stability of the Monetary Union as a whole, there is an emergency voting rule in which 85% of the votes of the Board of Governors are sufficient to pass a rescue program. The large countries Germany, France and Italy, each with a voting share of over 15%, can block decisions of the Board of Governors.[11]

A prerequisite for ESM grants is the ratification of the fiscal compact which obliges the euro area members to set an upper limit of the structural budget deficit of 0.5% of nominal GDP and to transfer the European debt rules into national legal order. Moreover, the regulations include a commitment by the countries with a public debt ratio over 60% to reduce it by an average of one twentieth per year. The ESM should only help if financial stability of the euro area as a whole and in its member states is at risk. Financial aid can be granted on the basis of an assessment of the sustainability of a crisis country's public debt and only if strict conditions are met within the framework of a reform and adjustment program that is negotiated and agreed with the governments of the debtor countries in a “Memorandum of Understanding”. Grants have to be paid back with interest and therefore cannot be regarded as transfers.

In contrast to the IMF, the ESM is only financed to a small extent through contributions from the member countries, but mainly through the issuance of bonds that are secured by a cash deposit (EUR 80.5 billion) and guarantees from the member countries. According to the current agreements, the ESM can lend a maximum of EUR 500 billion to debtor countries. The potential national losses depend on the shares in the ESM. For example, the maximum German loss is EUR 190 billion.

Institutionally, the ESM emerged from the EFSF. From the beginning, the ESM played a role in drawing up the economic adjustment programs. The ESM was involved in the programs for Cyprus and for the second and third Greece programs. The same applies to the program for Spain, which received funds from the ESM for its banking system, but no official rescue

[10] The Board of Governors of the ESM is even chaired b the President of the Eurogroup.
[11] See article 4 of the ESM Treaty.

program comparable to the other countries. The legal anchoring for this is Art. 13 (6) of the ESM Treaty and the provisions contained therein regarding an "early warning system" of the ESM.

The practice of euro area funds providing the financing while the Troika was responsible for implementing and monitoring the programs changed with the third Greek bailout program. The documents on the program implementation continued to be produced by the EU Commission in conjunction with the ECB (“in liaison with the ECB”), but it was explicitly pointed out that ESM staff should also participate in the monthly mission teams, which leads to the so-called “Quadriga” or the four institutions that replaced the Troika. The ESM justified this primarily with its large default risk against Greece's debt (Transparency International 2017, p. 19 f).

4. The problem of transforming the ESM into an EMF

4.1. Outline of an optimal EMF

A European Monetary Fund, which would replace the IMF in the event of a sovereign debt crisis within the euro area to prevent a sovereign default must - like the IMF - strike a balance. It has to trade-off the financing needs against the moral hazard problems that the expectation of external financing can lead to a misguided financial and economic policy, resulting in an even higher sovereign debt. In this respect, the IMF should act as a benchmark. Despite various criticism, the IMF has proven to be a useful supranational organization. Therefore, in the euro area financing should only be granted against conditionality, whereby the EMF has to develop a concept of how to deal with emergency loans. The conditions in a Monetary Union with a single monetary policy and the lack of the exchange rate instrument differ significantly from the political environment in which the IMF has operated in the past.

In principle, just like the IMF, the EMF should conduct a debt sustainability analysis before starting a reform program. Financing should not be granted to every euro area country and under all circumstances. Debt relief and private sector involvement in debt restructuring must be possible. In extreme cases, a sovereign default must also be possible. An exit of the euro area should be allowed if a member state had continuously violated the rules of the SGP and the Fiscal Compact and if it refuses to comply with the requirements of an adjustment program. Many politicians, economists and financial market participants believe that an exit is no longer feasible at acceptable costs and risks, and that it could be the beginning of a

breakdown of the euro area. On the other hand, the European Monetary Union will only gain the necessary credibility and support for its cohesion and survival in the long term if certain minimum rules are set and followed (see, e. g., Gros & Mayer 2017, p. 8 ff; Jost 2018, p. 6).

The decisive factor will be whether the ESM or a future EMF will be an independent institution. Such an institution should, regardless of the national governments and parliaments and the strong political influence of the EU Commission, regularly monitor the budget policy of the euro member countries on the basis of clearly defined, already established and agreed criteria (Deutsche Bundesbank 2016, p. 64; Fuest 2018). Another advantage of an independent monitoring of the budgetary rules would be that there would be no need to renegotiate the established crisis prevention measures. After the financial and economic crisis 2008/09, the euro area agreed on a set of rules with respect to the banking union, the tightening of fiscal rules and macroeconomic surveillance. Economists made more far-reaching and complicated proposals in recent years, which include additional grants and risk sharing, as well as rules to avoid moral hazard (e. g. Bénassy-Quéré et al. 2018). These proposals would require a change in the EU Treaty, the implementation of which is very unlikely in the near future. There is also the danger that governments will make use of and demand individual exemptions of the complex set of rules (e. g. regarding risk sharing) while pursuing related obligations (e. g. crisis prevention) only halfheartedly ("cherry picking").[12]

It is also important that the stabilization and reform programs are limited in time, as the IMF has been doing for decades. A country in crisis must be able to finance itself again on financial markets within a period of a few years and the repayment of the loans should be limited to 10 years. The transition to 30-40 years terms to maturity, as in the case of Greece, means that responsibilities cannot be proofed later and at the end of the programs which undermines the credibility of the programs' objectives.

An independent and strong EMF would have to take over the role of the IMF and must elaborate concepts for the development and strict monitoring of stabilization and reform programs. The EMF would have to decide according to clearly defined criteria whether a country receives a program and on what terms. For this purpose, it would make sense to base

[12] In the case of an initiative of 14 German and French economists, which drew up an extensive catalogue of reform proposals for the euro area (Bénassy-Quéré et al. 2018), Lars Feld, a member of the German Council of Economic Advisers, left the group because he feared precisely this risk.

the criteria on the already agreed rules of the SGP and the Fiscal Compact. For countries that violate these rules several times and thus increase the risk of a sovereign debt crisis on their own, access to potential funds from the EMF should be more difficult to prevent moral hazard behavior.

IMF programs and the IMF itself have never been popular in debtor countries. Many governments that started a reform program with the IMF were voted out of office or lost significant voting shares. This implies that it should not be attractive to apply for an EMF rescue program either. However, the IMF is usually "far away" - geographically and politically - from the country in crisis. A future EMF will be governed by EU member states or their finance ministers. Therefore, it will likely be under a high degree of political influence or pressure, similar to the EU Commission (Wyplosz 2017, p. 12). Thus, independence is the conditio sine qua non of an effective EMF.

Another challenge refers to the scope of the rescue programs. Funding from the ESM is limited. The ESM and EFSF together granted euro 204 billion in loans to Greece. In the event of a renewed crisis, in which larger countries might also have to be supported, the ESM would quickly reach its limits with its maximum borrowing capacity of euro 500 billion. However, a massive increase in the funding capacity of the ESM will hardly be enforceable in public and in the different national parliaments. This will open up the door for political pressure on the ECB to activate its Outright Monetary Transactions (OMT) program or another program to purchase sovereign bonds (Jost 2018, p. 6).

With respect to the required reforms, a European Monetary Fund has to pay more attention to the balance and resilience of the programs towards population and firms and the distributional consequences than in the previous crises. The reforms demanded by the Troika in the crisis countries quickly led to an increase in the tax burden of middle and lower income groups, a reduction in pensions and wages and an increase in consumption due to increases in Value Added Taxes. On the other hand, entrepreneurs and the wealthy parts of the population did not suffer due to capital flight and tax avoidance. However, the acceptance of the population for aid programs in a crisis crucially depends on the distribution of the burdens.

4.2. Current reforms of the institutional structure of the ESM

At the Euro Summit on December 14, 2018, important decisions were made regarding the institutional structure of crisis management in the future. Together with the EU Commission,

the ESM will take over the tasks of the former Troika or Quadriga. However, it should not be renamed to a European Monetary Fund and should remain an intergovernmental and not an EU institution. In this regard, the ECB, which found the notion “Monetary Fund” misleading, prevailed. A European rescue fund, such as the ESM, which will continue its work under extended tasks, is a fiscal and not a monetary fund. It is financed through contributions and guarantees of the member countries and through raising funds in financial markets, but not from central bank loans or reserve assets. The Fund (or, likewise, the ESM) therefore pursues fiscal, not monetary policy.

According to the agreements, the ESM should have two credit lines available in the future. A precautionary credit line that individual countries can access without program agreements if certain access criteria are met to calm financial markets. In the event of a serious crisis, a country can apply for ESM loans without conditions, but it has to adopt an economic adjustment program with conditionality with the ESM and the EU Commission (European Stability Mechanism 2018, p. 1). Therefore, in case of a major sovereign debt crisis in the euro area, in principle every country will get financial support without any preconditions. Only if negotiations fail, a no-bailout or exit of a country from the euro zone is possible. However, it is very likely that the EU Commission will prevent such an outcome by using political pressure on the negotiating partners. The political role of the Commission will be greater in the “two-party European team” of the ESM and the EU Commission than in the Troika or “Quadriga”. On the other side, the participation of an independent ESM could increase the credibility of the actions in the form of a political signal effect.

The cooperation between the ESM and the EU Commission is set out in 2018 in a "Memorandum of Understanding" signed by both institutions. Accordingly, the Commission and the ESM must jointly prepare a country's assessment of financial stability, the amount of financial support needed and debt sustainability. In cases where the two institutions disagree in their assessments, the Commission is responsible for the overall assessment of debt sustainability, while the ESM has to assess the likelihood of an ESM loan being repaid by the debtor country (European Commission/European Stability Mechanism 2018).

The agreements are less far-reaching than the proposals of the EU Commission of December 2017 in the form of a Council regulation establishing a European Monetary Fund. This regulation provides that a future EMF should be enshrined in EU law (EU Commission 2017).

Simplified voting rules should lead to faster flow of funds. Moreover, the EMF should be able to award more and more preventive relief funds with weakened conditions. The EU Commission even favored more funds to promote economic convergence in the euro area, to cushion asymmetric shocks and to provide European unemployment insurance. Emergency aid and back-up protection for banks in the euro area should also be expanded (EU Commission 2017; Bundesrechnungshof 2018, Meyer 2018).

In 2018, the German government and the Eurogroup of finance ministers agreed on significantly fewer tasks of a future EMF. The legal and institutional changes were only marginal. For example, future financial aid to crisis-hit countries should only be granted by the EMF if "financial stability of the euro area as a whole" is threatened. And financial support should only be granted against conditionality. Finance ministers and the governments of the euro area countries, whose taxpayers are ultimately responsible for the ESM loans, should also decide as unanimously as possible on the funds and the associated adjustment programs (Bundesrechnungshof 2018, p. 45). As already described, the IMF will no longer participate in future support programs within the euro area. The German federal government, one of the most determined supporters of IMF participation in the past, has given up its longstanding position in this regard.

In November 2020, the Eurogroup agreed to proceed with the reform of the ESM after protracted objections from Italy (Eurogroup 2020). The ratification of the revised Treaty will take place in the national parliaments in the course of 2021, so that it can enter into force at the beginning of 2022. The main purpose of the reform is to give the ESM more responsibilities within the framework of the Banking Union. The most important change is that the ESM should act as a common backstop for bank resolution. In the future, the ESM will be able to lend to the Bank Resolution Fund (BRF) if the BRF is in financial distress in the resolution of systemically important banks. The BRF is to be filled with just over 60 billion euros by the end of 2023, and the "backstop" is intended to reach the same level. At the same time, the existing, but never-used, possibility of the ESM to directly recapitalize banks will be abolished.

In addition, the ESM has a more important role to play in the future in dealing with heavily indebted euro area countries. From 2022, all euro area countries will have to include improved collective action clauses in their government bond issues. The ESM is authorized to moderate negotiations between a heavily indebted euro member country and private creditors. It will

also be given more powers to monitor "program countries". In this respect, the ESM will act on an equal footing with the EU Commission.

5. The role of Covid-19

The Covid-19 pandemic will have a huge impact on public finances in the EU (and worldwide). Debt levels will soar, especially in those EU countries that already were highly indebted before the crisis, e. g., Italy, Spain and France (ECB 2021). And the official management of the crisis changes the institutional responsibilities and the incentives for the countries. This will aggravate the institutional problems.

The first EU Corona package of May 2020 included a new precautionary credit line to the ESM, the Pandemic Crisis Support Instrument (PCSI). It has a volume of €240 billion and is limited until the end of 2022.[13] To reduce any stigmatisation effect caused by an application for the credit line, the new instrument contains a blanket preliminary assessment by the EU Commission that all member states are economically affected by the pandemic (European Commission 2020). The costs are lower than the usual conditions of the ESM and for some member states they are lower than their refinancing costs on the market (German Council of Economic Experts 2020, p. 166). At the end of 2020 no country activated the PCSI.

The pandemic has led to a common European fiscal response in the form of the €750 billion credit-financed "Next Generation EU" (NGEU) package, finally agreed by EU leaders in December 2020. It is centred around a Recovery and Resilience Facility with a €672 billion envelope consisting of €360 billion in loans and €312.5 billion in grants (ECB 2021). This rescue and recovery program will not be financed by ESM resources and will not be monitored by the ESM. To receive financial support, EU countries need to draw up national recovery and resilience plans in which the countries set out their reform and public investment agenda for the years 2021-23 (ECB 2021). One important novelty of this package is that it will involve, for the first time, the issuance of common European debt by the end of 2026 at the latest.[14] Part of this debt, €390 billion, will be in the form of grants to individual EU countries, earmarked

[13] One immediate pandemic-related initiative at the EU level was the activation of the general escape clause of the SGP. This clause allows for a coordinated and temporary deviation from the usual fiscal requirements of the SGP for all Member States provided that this does not endanger fiscal sustainability in the medium term (ECB 2021).

[14] The repayment schedule is until the end of 2058.

to finance crisis management and strengthening convergence, resilience and change in the EU. These grants will have to be serviced by EU sources of funding. The rest, €360 billion, will finance loans which have to be repaid by Member States. Whereas most of the grants are allocated according to national criteria (population, unemployment, GDP per capita), the terms and conditions of the loans are based on the EU's refinancing costs (Deutsche Bundesbank 2020, p. 79ff.). Therefore, member states with a very good credit rating will refrain to use the EU loans.

The financing of loans to EU countries by the NGEU package competes with the ESM-PCSI (German Council of Economic Experts 2020, p. 173). The requirements of the latter are deliberately set low to reduce political reservations and to facilitate drawdown. By contrast, the conditions for the loans via the Next Generation EU package are linked to reform and investment plans, which are to be assessed and approved by the other countries. However, unlike the ESM, no additional resources are currently earmarked for loan monitoring and processing at the EU Commission. There are probably political reasons for not using the ESM program while at the same time using the loans from the EU package (German Council of Economic Experts 2020, p. 173).

In the course of 2020, the ECB also decided a crisis-related monetary policy package, the so-called Pandemic Emergency Purchase Program (PEPP). At the end of December of 2020, it amounted to €1,850 billion. National government bonds make up the biggest share of the PEPP. It is forecasted that the volume of these purchases of government bonds (PEPP and the ongoing QE program) is close to the increase in public debt between 2019 and 2021 (German Council of Economic Experts 2020, p. 92). Against this background, it is hardly surprising that even highly indebted member states are still able to fund themselves in the bond market. Thus, the PEPP has so far also prevented the countries from using the credit lines of the ESM Pandemic Crisis Support Instrument.

5. Summary and conclusions

The successful management of future sovereign debt crisis necessitates that the euro area must be in a better position, legally, institutionally and in the design of economic adjustment programs. The IMF will no longer be available as a donor and as an active part in the designing and monitoring of reform programs.

The ECB will also no longer participate in the formulation and monitoring of rescue programs. The ECB has a narrow mandate to maintain price stability in the euro area. In the event of financial crises or in the extreme case of a balance of payments or sovereign debt crisis in the entire euro area, the ECB will act as a lender of last resort. However, the ECB has no mandate to specify or monitor structural and economic reforms in individual countries in detail as part of adjustment programs. Through the ELA liquidity support for troubled banks, the ANFA and the QE programs, the ECB has exhausted all possibilities to support the financial system in the crisis countries and to ease government debt financing of countries in crisis. Limiting the role of the ECB would be desirable for the reputation and independence of the ECB as well as the clear delimitation of responsibilities and risks.

Following the EU decisions of December 2018, the ESM will be transformed into a "European Monetary Fund", although it will not adopt this name and will be different from the IMF in terms of institution, tasks, instruments and funding. In its central task of assisting countries in a sovereign debt crisis with conditional loans it should, however, follow the IMF's "benchmark" in key institutional features and philosophy. To avoid moral hazard problems, conditionality needs to be as strict as at the IMF. In addition, for countries that have repeatedly violated the rules of the European Stability and Growth Pact and the Fiscal Compact, it should be significantly more difficult (more expensive) and more uncertain to get the required funding.

The ESM should therefore be involved in the ongoing monitoring of the agreed fiscal rules and objectively identify its violations (Fuest 2018). For that purpose, the EMF should optimally be one of the European institutions and, in particular, be independent of the EU Commission. In contrast, the decisions suggest that the EU Commission will play a dominant role in determining the financial needs of a country in crisis and in developing a rescue program. In an emergency case, all crisis countries will get support. The precedent is Greece, whose reform efforts the EU Commission itself assessed to be inadequate even 9 years after the rescue programs began.

The funding of the ESM or a future EMF and the guarantees for borrowing are taken over solely by the donor countries. They bear the risks and therefore decide on the tools and programs in the Board of Governors. Democratic control takes place via the national parliaments which represent the interests of national taxpayers. In fact, the new institutional

setting effectively overrides the no-bailout clause of the EU Treaty. Unlimited aid without or with only soft conditions would actually mean a transfer union that has not been decided yet. For this reason, a sovereign default or a country leaving the euro area must be possible if it does not accept financial aid in the event of a crisis or does not accept the conditions of a stabilization and reform program.

A key problem is the rapid build-up of the necessary expertise in the ESM for the event of a potential new sovereign debt crisis. Greece's outstanding debt and their interest and repayment arrangements are a burden on the ESM. In the case of Greece, the ESM cut interest rates very sharply and extended the repayment periods extremely which in fact amounts to a substantial haircut. Future debtors could use this example as a guide and thus provoke a rescue via the ESM, which would ultimately be significantly cheaper than market financing. The corona pandemic will dramatically increase public debt in the euro area. A future debt crisis could therefore evolve whose European solution quite necessarily calls for ESM activation. Actions by other European institutions (e.g., the ECB), political pressure and national interests might once again hinder an effective crisis management at the EU level.

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