



Wilfried

Martens Centre
for European Studies

Reforming the European Stability Mechanism

Too Much but Never Enough

Anna Peychev





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Credits

The Wilfried Martens Centre for European Studies is the political foundation and think tank of the European People's Party (EPP), dedicated to the promotion of Christian Democrat, conservative and like-minded political values.

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Table of contents

About the Martens Centre	06
About the author	08
Executive summary	10
Introduction	14
The ESM	18
Facts	19
Shortcomings	21
Justiciability	21
Voting procedures	22
Debt sustainability analysis and debt restructuring	22
Losing market discipline	24
The black hole of the Eurogroup	25
Attempting reform	26
The Juncker Commission's push to complete EMU	27
Resistance	30
The Hanseatic League	30
Klaus Regling	31
The Meseberg Declaration	32
The Eurogroup	33
The ESM Reform Treaty	34
The common backstop	35
Precautionary conditioned credit lines	36
Debt sustainability, restructuring and analytical capacities	37

New competences	39
Peacetime powers	39
Peacetime powers: questions	41
Peacetime powers: inappropriate liaisons	42
EMU ideology	44
Theorising EMU	45
Practicing EMU	46
The times they are a-changin'	47
Conclusion	50
The history of the ESM Reform Treaty	51
Distrust	51
Content of the ESM Reform Treaty	52
Old problems	52
New problems	52
Future limits	53
Recommendations	56
Immediate concerns: ESM Reform Treaty	57
Long-term concerns: reforming the ESM Reform Treaty	58
Reforms under public international law	59
Reforms under EU law	60
Bibliography	62



About the Martens Centre



The Wilfried Martens Centre for European Studies, established in 2007, is the political foundation and think tank of the European People's Party (EPP). The Martens Centre embodies a pan-European mindset, promoting Christian Democrat, conservative and like-minded political values. It serves as a framework for national political foundations linked to member parties of the EPP. It currently has 31 member foundations and two permanent guest foundations in 25 EU and non-EU countries. The Martens Centre takes part in the preparation of EPP programmes and policy documents. It organises seminars and training on EU policies and on the process of European integration.

The Martens Centre also contributes to formulating EU and national public policies. It produces research studies and books, policy briefs and the twice-yearly *European View* journal. Its research activities are divided into six clusters: party structures and EU institutions, economic and social policies, EU foreign policy, environment and energy, values and religion, and new societal challenges. Through its papers, conferences, authors' dinners and website, the Martens Centre offers a platform for discussion among experts, politicians, policymakers and the European public.

About the author



Anna Peychev is a visiting fellow at the Martens Centre. She is an expert on Economic and Monetary Union governance, specifically the European Semester and the European Central Bank. Dr Peychev obtained her doctorate from Kent Law School, University of Kent, with her research analysing the legislative aftermath of the EU sovereign debt crisis. She has previously earned an LLM in international law at the Brussels School of International Studies and a Bachelor's degree in international relations from the University of Calgary, Canada.

Executive summary



On 27 January 2021 the member governments of the European Stability Mechanism (ESM) signed the Agreement Amending the ESM Treaty, instituting long-awaited reforms to the EU's crisis-management and financial-aid mechanism. The ESM was never perfect. Set up outside the EU treaty framework, it suffered from acute accountability and legitimacy issues and, being directly controlled by eurozone governments, its procedures were subject to cumbersome voting arrangements and conflicts of interest. Finally, with its inception in the throes of the eurozone crisis, it was committed to a single rigid approach based on conditionality.

The European Commission's attempt to address these shortcomings in December 2017 was categorically rejected by the member states, who instead embarked on a separate reform initiative resulting in the current ESM Reform Treaty. This turn of events has been in part motivated by troubling levels of distrust between EU institutions and member states, and—as a result—between EU institutions and the ESM. The other driving force has been the political refusal to let go of the Maastricht promise of national fiscal sovereignty without shared liabilities. Thus, the ESM Reform Treaty is the culmination of a political campaign to redeem the economic compromise at the core of the Economic and Monetary Union and create an alternative arrangement for member states to avoid surrendering further competences to the EU.

This paper finds that the ESM Reform Treaty not only fails to address the outstanding issues in the original ESM framework, but exacerbates the status quo by further empowering the Mechanism outside the legal framework of the EU treaties. The ESM's 'peacetime powers' represent a consequential novelty in this regard. These 'powers' are in fact the ESM's own analytical capabilities, which have been extended beyond its financial-aid function and are now applicable within the bounds of the European Semester for economic governance. Perhaps worst of all, the ESM remains an extremely limited instrument, legally designed to imagine the single scenario of a sovereign debt crisis which requires disciplinary conditionality in exchange for financial aid. It would be careless to insist on this approach for resolving the multitude of difficulties which might befall the eurozone in the future.

Future reforms are not just advisable, they are a functional necessity. It will become increasingly difficult for the ESM to exercise its new powers or provide suitable crisis management without the efficiency and legitimacy which these adjustments could confer.



A compromise solution could see the ESM become its own independent technocratic institution, equally removed from the political influence of governments and the reach of the Commission. Introducing flexibility in its strict conditionality could be a matter of reinterpreting the meaning of ‘sound budgetary policy’ from the Court of Justice of the European Union’s ruling in *Pringle*. Lastly, in matters of justiciability and the protection of fundamental rights, nothing prevents ESM governments from committing the activities of the Mechanism to the European Charter on Fundamental Rights or the authority of the European courts, should they wish to do so.

Whatever decisions may be taken on the future of the ESM, they cannot ignore the unfolding of the EU’s fiscal response to the pandemic with Next Generation EU. Should the facility remain an exception, there would be even more pressure on the ESM to undergo another round of far-reaching reforms. However, should Next Generation EU prove a positive exercise, the EU should look to capitalise on the newfound trust by consolidating its economic and crisis governance capacities under a single flag—a certain blue one with 12 gold stars.

Keywords European Stability Mechanism – Economic and Monetary Union – EU – Intergovernmentalism – Reform – Crisis – Economy



Introduction



The European Stability Mechanism (ESM) was born of a crisis—an exceptional measure for an exceptional circumstance. It was the solution to the impasse of the European sovereign debt crisis, which saw the future of the entire EU project set against its own legal framework. Greece, then Spain, Ireland, Portugal and Cyprus were badly in need of financial aid in spite of the EU treaties' explicit prohibitions on sovereign debt financing.¹ However, it was widely believed that letting these countries default would be tantamount to putting an end to the single currency project and was, therefore, to be avoided at all costs.

The early stages of the crisis were managed through the stopgap European Financial Stability Facility, set up in Luxembourg as a special purpose entity and financed by eurozone governments. It was complemented by the European Financial Stability Mechanism operated by the European Commission. As the crisis intensified in 2012, governments decided to make the financing mechanism a permanent institution, thus creating the ESM. This was considered a signal to the markets of the European resolve to safeguard the euro project.

Yet, the infamous bailout prohibitions of the EU treaties remained a legal obstacle to this endeavour. The ESM would hence have to be set up outside the bounds of EU law, a solution sanctioned by the Court of Justice of the European Union (CJEU) in *Pringle*. The Court balanced the otherwise illegal bailouts with the application of proportional conditionality.² This exercise of judicial legalisation helped shape the ESM into the institutional avatar of the turbulent times it was born of—focused on debt responsibility, bound by a fiduciary responsibility to its shareholders (the creditor member states) and intent on enforcing fiscal discipline.

But the Mechanism also came with many shortcomings reflective of its ad hoc character. Therefore, in December 2017, under the leadership of Jean-Claude Juncker, the European Commission published a list of legislative proposals to advance the completion of the Economic and Monetary Union (EMU) and to incorporate the ESM into EU law. However, the reform ideas did not sit well with a number of member states, who refused to engage with the Union's legislative procedure. Instead, they initiated

¹ The infamous 'no bailout' clauses—art. 123 of the Treaty on the Functioning of the European Union (TFEU) for the European Central Bank (ECB) and art. 125 TFEU regarding Union and member state involvement.

² CJEU, Case C 370/12, *Pringle v Government of Ireland* [2012] ECLI:EU:C:2012:756.



a separate reform process that was spearheaded by the Eurogroup with the blessing of national governments. Completing this process, on 27 January 2021 ESM member governments, represented by their ambassadors to the EU, signed the Agreement Amending the ESM Treaty (the ESM Reform Treaty).³

The following pages are a study of the legal and political background behind these latest reforms of the ESM. Section 1 reviews the basic functions and governance set-up of the ESM, followed by a brief review of its more contentious features. Section 2 delves into the European Commission's proposals for reform, followed by an account of the political backlash to these ideas. Section 3 then discusses the compromise solution—the ESM Reform Treaty and its most significant new features. To better understand the motivations behind the political and governance choices which shaped the final Reform Treaty, Section 4 takes a brief look back to the origins of the EMU with the establishment of the Maastricht compromise. In conclusion, Section 5 outlines the major lessons learned from the study as a list of outstanding problems, which sets up the forward guidance reform recommendations in Section 6.

³ The final signature was provided on 8 February 2021 and the Reform Treaty is now pending national ratification procedures.



The ESM



Facts

The ESM is a *for-profit multinational shareholder corporation* established in Luxembourg as the successor to the European Financial Stability Facility. The Mechanism provides stability support to eurozone governments experiencing or threatened with financial difficulties, provided that their troubles are likely to affect the stability of the entire euro area.⁴ In essence, the ESM carries out ‘lender of last resort’ (LLR) functions for sovereigns.

Financial assistance from the ESM comes with strict conditionality, which is supposed to

- act as a legal bypass to the EU treaties’ financing prohibitions;
- ensure the enforcement of disciplinary structural reforms in borrower member states; and
- protect against the moral hazard of a financial safety net, dissuading governments from becoming overly reliant on others’ help.

The ESM is set up as a treaty under public international law, not EU law. However, it operates *between* legal regimes. The Mechanism is

- understood to be born of EU legal arrangements with the infamous amendment to Article 136 of the Treaty on the Functioning of the European Union (TFEU), which allowed for its creation on the grounds of conditionality;
- designed to operate for the purposes of the EU in that it supports the economic and financial stability of the eurozone;
- proceduralised and governed through EU regulations, most prominently Regulation (EU) no. 472/2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability; and
- operationalised through EU institutions—the Commission and the European Central Bank

⁴ Art. 3, *Treaty Establishing the European Stability Mechanism* (2 February 2012) (ESM Treaty).



(ECB)—to which the ESM outsources the assessment of debt sustainability, negotiation of terms for financial help and monitoring of compliance, amongst other responsibilities.

The ESM is managed by its Board of Governors (BoG) and Board of Directors (BoD). An important figure is the managing director—currently Klaus Regling—who is appointed by the BoG and is responsible for conducting the daily activities of the ESM on the instruction of the BoD.

The BoG is comprised of the eurozone ministers of economics and finance, otherwise known as the Eurogroup. Similarly, the BoD is comprised of the individuals who sit on the Eurogroup Working Group, which supports the work of the Eurogroup. While these are literally the *same people*, their interactions are indeed quite distinct in the context of the ESM and the EU. In Luxembourg, unlike in Brussels, there is no pretence that EU sovereigns are somehow equal peers. That is to say, the ESM quantifies and operationalises sovereign financial power. It does so by equating the voting rights of the members of the BoG with their ESM buy-in.⁵ This means that governments' ESM shares and respective voting rights are determined by the size of their population and GDP relative to the entire eurozone, that is, by their economic prowess.

This turns the ESM into a corporate iteration of the Eurogroup. Even if the Mechanism's formal function is ad hoc stability support for the eurozone, it has to manage this responsibility without prejudice to its '*fiduciary duty* to act in the interest of its shareholders'.⁶ This 'shareholder interest' comes down to minimising the risk of debt-sharing by ensuring loans are repaid in full. Moreover, the financial operations and governance considerations of the ESM are carried out *for profit*—the ESM actually stands to benefit from its operations and especially those conducted on the secondary bond markets.⁷

In a certain way, the governance arrangements of the ESM are a perfect reflection of the historical context of the Mechanism's foundations, ensuring that it is its member states—rather than the collective Union—which exercise ultimate control over the funds they contribute to the bailout venture.

⁵ The buy-in is based on the capital key of the ECB (art. 4.7 ESM Treaty).

⁶ Hanseatic League, 'ESM Reform' (8 November 2018) (emphasis added).

⁷ As per art. 18 ESM Treaty. The calculation is indeed quite simple—the ESM intervenes in the sovereign bond markets when a certain government's bonds are already trading at spectacularly low prices with uncomfortably high interest exacted by the markets. Once financial panic has been pacified—in part due to the ESM's interference and buying up of otherwise unpopular government bonds—the borrower government restores its market access and bond prices rise. At this point, the ESM—now a major creditor of the troubled government—has automatically made a profit on the extended credit.



Shortcomings

Yet, unsurprisingly, the ‘anything goes, whatever it takes’ approach of the euro crisis resulted in some unnatural solutions. These, in turn, have been the source of shortcomings in the Mechanism’s functionality, governance and relationship with the law.

Justiciability

Even if the Commission and the ECB negotiate—and the Commission signs—the memoranda of understanding which set out the conditionality terms for ESM financial aid, their activities under the ESM Treaty commit the ESM alone, and their involvement does not alter the legal nature of ESM acts, which fall outside the EU legal order. The only protection under EU law against acts of the ESM, then, is indirect: since the ESM Treaty tasks the Commission with reviewing the terms of the memoranda of understanding for consistency with EU law, the CJEU holds that the Union’s non-contractual liability could be triggered if the Commission were to contribute to a sufficiently serious breach of individual rights.⁸ The ESM itself, however, is fully insulated against any liability under EU law.

It is thus an unfortunate vicious circle with little recourse to justiciability, which is detrimental to the legal coherence and protections of the Union. It is a set-up which severely undermines the trust and good governance practices worthy of a community based in law, such as the EU, and deserves to be addressed comprehensively.⁹

⁸ The Commission’s obligation as ‘guardian of the treaties’ is codified in art. 17 of the Treaty on European Union. The CJEU has had multiple chances to opine on the Commission’s responsibilities under the ESM. See CJEU, Joined Cases C-8/15 P to C-10/15 P, *Ledra Advertising et al. v European Commission and ECB* [2016] ECLI:EU:C:2016:701, paras. 55, 58; and CJEU, Case C 370/12, *Pringle v Government of Ireland* [2012] ECLI:EU:C:2012:756, para. 164.

⁹ According to the Commission’s own assessment, the parallel existence of the ESM has complicated matters with ‘judicial protection, respect of fundamental rights and democratic accountability’ (European Commission, *Proposal for a Council Regulation on the Establishment of the European Monetary Fund*, Proposal, COM (2017) 827 final (6 December 2017), 3).



Voting procedures

Another serious problem with the ESM's original framework is the voting procedures that call for unanimity for more or less any act of consequence. This allows any single member to block time-sensitive processes based on the imposition of strictly national conditions on the adjustment programmes demanded of borrowing governments.

The emergency voting procedure is not much of a fail-safe in this regard. It has a very high threshold for activation—only if both the Commission and the ECB decide that a delay in reaching a decision amongst the ESM members risks serious consequences to the stability of the eurozone. Furthermore, with 85% of the capital shares sought for approval, three governments are still capable of vetoing procedures—Germany, France and Italy.

The Commission has rightly observed that these cumbersome voting arrangements hardly comply with the nature of a crisis-resolution body, which is expected to act swiftly and decisively.¹⁰

Debt sustainability analysis and debt restructuring

Third, we cannot ignore the ESM's conflict of interest regarding public debt sustainability analyses (DSAs).¹¹ These are the documents whose conclusions define the terms and conditions for ESM financial aid and the possibility of debt restructuring.

Most crudely, the logic of DSAs comes down to a balancing equation between

- a troubled government's incurred debts;

¹⁰ Ibid., 3.

¹¹ For details on debt restructuring see recital 12 ESM Treaty; on DSAs see art. 13.1 ESM Treaty and European Parliament and Council Regulation (EU) no. 472/2013 on the strengthening of economic and budgetary surveillance of member states in the euro area experiencing or threatened with serious difficulties with respect to their financial stability, OJ L140 (17 May 2013), 1.



- the financial aid granted by the ESM—which helps settle immediate concerns, but ultimately adds to long-term debt; and
- the fiscal savings expected through various structural reforms outlined in the government’s conditionality programme.

Generally, it is not advisable to issue new loans to a government whose debt is judged unsustainable. First, it is a bad investment strategy with little promise of repayment. Second, it risks exacerbating the underlying problems even further.¹²

Barring sovereign default, the solutions include

- revisiting the terms of the financial aid package—for instance, renegotiating repayment schedules to make individual payments financially bearable;
- revising the assessment of the conditionality programme towards more optimistic conclusions;
- demanding further austerity measures for further spending reductions; and
- implementing debt restructuring.

As unappealing as debt restructuring might be in political and financial circles, the alternatives provide false solutions. Extending the repayment schedule only prolongs a borrower’s struggle to balance its accounts and recover, while the total debt burden remains unchanged and is to be shouldered by generations in an even more distant future. Over-optimistic conclusions on austerity reforms lead to unreasonable expectations for recovery and a possible repeat of the doom cycle. Demanding further fiscal tightening risks public rejection of the programme, political backlash and stagnant growth. Most

¹² The International Monetary Fund (IMF) has a clearly established practice on this. For a succinct summary, see S. Hagan, M. Obstfeld and P. M. Thomsen ‘Dealing with Sovereign Debt—The IMF Perspective’, *IMF Blog*, 23 February 2017.



unfortunately, the practices of the ESM have not fared well in this regard.¹³

With the current ESM Treaty, DSAs are carried out by the Commission and the ECB, but the final decision—with all its implications for debt repayment—is taken by the ESM. Yet, as a result of the European internal market for financial services, the ESM BoG represents a significant proportion of a troubled government’s private creditors. In essence, the free movement of capital and financial services in the integrated market has meant that member states and nationally-incorporated financial entities can become investors (and creditors) across national borders within the EMU. The trouble is—as investments cross borders, so does risk. For example, think of the German and French banks with their unhealthy doses of exposure to Greek debt during the eurozone crisis. In the context of the ESM, this means that a creditor state’s vote on debt sustainability could potentially be a vote on ‘bailing in’ its financial institutions and—by extension—itself.

With the current legal and procedural framework, ESM members must balance their national interests against the Mechanism’s mandate to ensure the stability of the eurozone—an exercise that has not always yielded the most logical or optimal results.

Losing market discipline

Debt restructuring is to markets what conditionality is to governments. Forced austerity, rough lending terms and a certain loss of sovereignty are expected to discourage governments’ fiscal profligacy and prevent future crises. Analogously, a realistic possibility of debt forgiveness is supposed to scare market investors into responsible lending, so that they price risk accordingly and, in turn, help to discipline government borrowing and spending.

¹³ A now infamous case in point is illustrated by the unprecedented public showdown between the IMF and the EU during the third programme review for Greece in 2016. The creditors disagreed over the sustainability of Greek debt and their assessment of the future growth scenarios of the country, specifically the budget surplus targets. Their numbers simply did not match. The IMF advocated for serious debt restructuring before it could provide additional financial support; the EU fell back on claiming protracted repayment of the loan in full as a kind of debt restructuring spread out over time. Matters deteriorated so much that two top IMF officials published an open letter warning of the Fund’s projections and against the EU’s new conditions for more austerity. See P. Thomsen (director of the IMF’s European department) and M. Obstfeld (IMF chief economist), ‘The IMF Is Not Asking Greece for More Austerity’, *IMFBlog*, 12 December 2016.



This approach is, however, far removed from the current EU crisis-management mechanism. Not only has the ESM made sovereign defaults impossible, but its approach to debt restructuring during the crisis set up the expectation that member states will always pay their debts and do so in full. Thereby, the incentives that help to ensure the market is a constructive disciplinary actor have been severely weakened.

The black hole of the Eurogroup

Last but not least, in discussing the ESM's structural problems, we must address the complicated role of the Eurogroup.

The Eurogroup is neither a body nor institution of the EU per treaty definition.¹⁴ It is an informal gathering of the eurozone ministers of economy and finance, advertised as a forum for discussion. Officially, the Eurogroup has no legal competence to make decisions, even if it prepares them for the Council through its deliberations. This spares it from EU legal and democratic oversight, which has resulted in it having a contentious track record on transparency and accountability. The other function of the Eurogroup's members as the ESM's BoG complicates matters further.

A major issue is the unregulated information flow between the two entities. Legally, eurozone ministers in their role as Eurogroup members have access to information which eurozone ministers in their role as ESM governors should not. Moreover, ministers' exposure to liability and oversight strictly depends on the format under which they meet, whether as Eurogroup members or as the ESM BoG—something which has often been difficult to pin down.

This leaves a general feeling that enormous decision-making power regarding the future of the eurozone and troubled member states is wielded in a black hole. The Office of the European Ombudsman has taken particular issue with this situation, along with prominent non-governmental organisations such as Transparency International.¹⁵

¹⁴ To this end, see the most recent confirmation by the CJEU, Case C-597/18 P, *Council v K. Chrysostomides & Co. and Others* [2020] ECLI:EU:C:2020:1028, paras. 84–90.

¹⁵ An informative exchange in this regard is the back and forth between the offices of the president of the Eurogroup and chair of the ESM, then Jeroen Dijsselbloem, and of Emily O'Reilly, EU ombudsman, on transparency and accountability issues, specifically concerning public access to documents. The altercation can be followed starting with Ms O'Reilly's letter from 30 August 2016. See European Ombudsman, 'Follow-up Response from the European Ombudsman to the Reply of President Dijsselbloem to Her Letter Concerning Eurogroup Transparency' (29 August 2016). For the Transparency International report, see L. Hoffmann-Axthelm, 'Vanishing Act: The Eurogroup's Accountability', *Transparency International* (2019).

Attempting reform



The Juncker Commission's push to complete the EMU

Aware of these deficiencies, in December 2017 the Juncker Commission proposed a legislative package of measures committed to completing the EMU and to incorporating the ESM into the EU treaties under Article 352 of the TFEU.¹⁶ The proposals sought to address the multiple governance, legal and legitimacy issues inherited from the eurozone crisis.¹⁷ It was a forward-looking endeavour, which significantly miscalculated the political climate of the time.

Here follows a brief discussion of the most important aspects of the Commission's vision for the future ESM.¹⁸ Apart from the superficial renaming of the ESM as the European Monetary Fund, the Commission entertained five significant amendments.

First, the future ESM was to include a common backstop to the Banking Union's Single Resolution

¹⁶ Art. 352 TFEU is the 'flexibility clause' of the treaties, which allows the EU to take appropriate measures under the regular legislative procedure in the pursuit of a treaty objective for which a procedural mechanism has not been secured

¹⁷ The December package of documents consists of European Commission Communications 821–7 from 2017: *Further Steps Towards Completing Europe's Economic and Monetary Union: A Roadmap*, Communication, COM (2017) 821 final (6 December 2017); *New Budgetary Instruments for a Stable Euro Area Within the Union Framework*, Communication, COM (2017) 822 final (6 December 2017); *A European Minister of Economy and Finance*, Communication, COM (2017) 823 final (6 December 2017); *Proposal for a Council Directive laying down provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the member states*, Proposal, COM (2017) 824 final (6 December 2017); *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2017/825 to increase the financial envelope of the Structural Reform Support Programme and adapt its general objective*, Proposal, COM (2017) 825 final (6 December 2017); *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) no. 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) no. 1083/2006 as regards support to structural reforms in member states*, Proposal, COM (2017) 826 final (6 December 2017); and *Proposal for a Council Regulation on the Establishment of the European Monetary Fund*, Proposal, COM (2017) 827 final (6 December 2017).

¹⁸ As laid out in European Commission, *Proposal for a Council Regulation on the Establishment of the European Monetary Fund*; and European Commission, *A European Minister of Economy and Finance*, Communication, COM (2017) 823 final (6 December 2017).



Fund, providing emergency liquidity assistance whenever the extant banking insurance framework was unable to cope alone.

The second reform concerned ESM voting procedures, noted as being inhibitive of resolute decision-making. The Commission planned to do away with the unanimity requirement for the majority of important decisions, instead lowering the regular threshold for successful votes to that of the emergency procedure—at 85%.

The third proposal allowed for the direct involvement of the ESM in the management of financial assistance programmes—from negotiating and co-signing memoranda of understanding to compliance surveillance. Such a move had great potential for streamlining the accountability of the instrument, especially with regards to its most controversial operations involving conditionality arrangements. Simply put, direct management would have led to the explicit accountability of the ESM for its own actions, greatly alleviating the burden mistakenly placed on the Commission in the original treaty scheme. Furthermore, since the Mechanism was expected to become part of the EU legal and regulatory framework, this new accountability would have been readily enforced by the CJEU with the justiciability of the ESM’s expanded powers thus safely presumed.

European law presupposed European oversight. Under the Commission’s scheme the ESM would have been exposed to heightened democratic accountability with access granted to both European and national parliaments. The Mechanism’s operations would have become subject to the oversight powers of the European Anti-Fraud Office, as well as the European Court of Auditors.¹⁹ European regulations on transparency would have ensured public access to ESM documents.²⁰ All acts of the ESM and its associated bodies would have been obliged to fully observe the provisions of the Charter of Fundamental Rights of the European Union.²¹ Last but not least, the direct exposure to the full effects of European law—both its obligations and protections—would have secured the justiciability of EU crisis governance

¹⁹ European Commission, *Proposal for a Council Regulation on the Establishment of the European Monetary Fund*, Annex, art. 45.

²⁰ Specifically, it would have been subject to European Parliament and Council Regulation (EC) no. 1049/2001 regarding public access to European Parliament, Council and Commission documents, OJ L 145 (31 May 2001), 43, as per the proposals in European Commission, *Proposal for a Council Regulation on the Establishment of the European Monetary Fund*, Annex, art. 46.

²¹ Specifically art. 28 of the Charter of Fundamental Rights of the European Union and art. 152 TFEU, as per the proposals in European Commission, *Proposal for a Council Regulation on the Establishment of the European Monetary Fund*, Annex, art. 12.



and removed the immense legal burden placed on the Commission to act as a legal bridge between the EU and ESM treaties.

Apart from these amendments, the ESM was to retain much of its structure and operational scheme, except that the president of the Eurogroup would become the only possible candidate to chair the ESM's BoG.²²

The importance of this seemingly unremarkable proposal only made sense in the context of the complementary Communication *A European Minister for Economy and Finance*, in which the Commission entertained merging 'the function of Commission Vice-President in charge of the Economic and Monetary Union with that of President of the Eurogroup'.²³ This future EU minister of finance 'would exercise a neutral role, taking into account the interests of the shareholders of the European Monetary Fund *in a balanced manner*'.²⁴

The reform would have carried serious implications. Most obviously, it would have significantly expanded the Commission's competences.²⁵ Also, it would have done away with the pretence of a Chinese wall between the ESM and the Eurogroup in terms of information flow, decision-making authority and liability. The effective 'takeover' of the Eurogroup could have subjected the body to the same scrutiny as any formal EU body or institution—formalising its workings and lifting the veil of secrecy from this remarkably powerful and regrettably unaccountable entity.

But perhaps the most curious consequence of the Commission's proposal had to do with the proposed minister's responsibility to act in a 'neutral and balanced manner'. The mere mention of balance was an obvious acknowledgement of the multiple and distinct interests at play in securing the stability of the eurozone during financial crises—both EU interests and ESM interests. With this turn of phrase the Commission opened the door—if ever so slightly—to a new approach to EU crisis management which could have endangered the ESM's fiduciary responsibility to its shareholders, the focus on debt-sharing risk-aversion and possibly even the for-profit business model of the institution.

²² Currently, members can opt for an alternative choice of representative in a vote amongst themselves.

²³ European Commission, *A European Minister of Economy and Finance*, 2.

²⁴ Ibid., 7 (emphasis added).

²⁵ European Parliament, 'Legislative Train, Integration of the ESM into EU Law by Way of Creating a European Monetary Fund (EMF)', (January 2021).



Indeed, the Juncker Commission's December 2017 reform package was an audacious proposal. Bringing the ESM into EU law was part of a grander scheme which sought to consolidate the coordination and cooperation of economic affairs and crisis management within a single legal framework capable of speaking with one voice and acting decisively as the need arises.

Resistance

However, the European political establishment remained generally unimpressed with the Commission's proposal. In fact, it was rather aggravated. By April 2018 the regular legislative procedure on the regulation looking to incorporate the ESM into the treaties had de facto ceased.

The Hanseatic League

The first salvo came from a group of member states that had branded itself the New Hanseatic League. It comprised eight fiscally consolidated austerity hawks: Estonia, Finland, Ireland, Latvia, Lithuania, and the non-eurozone Denmark and Sweden, all under the leadership of the Netherlands.

In a public statement from 6 March 2018, the League seemingly agreed to a majority of the Commission's reform proposals and also advocated for a reinforced procedure for debt restructuring.²⁶ But the League expressed open hostility to any changes to the intergovernmental character of the ESM and its voting arrangements.²⁷ These were judged to be strategically connected to the commitment to conditionality that was at the core of the ESM.

²⁶ In particular, they agreed on the ESM's involvement in the development and monitoring of financial assistance programmes, some kind of a Banking Union backstop and a re-christening of the ESM as the European Monetary Fund for no apparent purpose. See Hanseatic League, 'Position EMU Denmark Estonia Finland Ireland Latvia Lithuania the Netherlands and Sweden' (6 March 2018).

²⁷ The proposed reforms to the voting procedure would have exclusively impacted the rights of this particular group of member states, leaving them holding insufficient shares to veto and making them wholly dependent on mostly German consent in such matters, as their principal ally on fiscal prudence.



With unanimity required in the Council for several of the Commission's reform proposals, the League's early disagreement made further discussions futile.²⁸ The result of this intervention was likely as intended—the suspension of the latest wave of EMU reforms, specifically those in the form imagined by the Commission.²⁹

Klaus Regling

A month later, the ESM itself tuned into the debate with a speech by Managing Director Klaus Regling. In it, he outlined a very different vision for the institution's future than the one proposed by the Commission, making two significant interventions.³⁰

First, Mr Regling outright rejected the ESM's incorporation into EU law on a somewhat unconvincing pretext. He claimed that the legal basis chosen by the Commission—the 'flexibility clause' of Article 352 of the TFEU—would somehow obstruct the ESM's efficacy and independence.

The argument for efficacy was unclear; the one for independence confusing. Never had the work of the ESM been directly connected to the discourse and practicalities of political independence, as, for instance, is the operation of central banking. The ESM's voting arrangements and constitution as a body representative of eurozone governments' financial interests simply did not qualify it to entertain such considerations. That unfortunately left the Commission and the ECB as the only suspects from which this independence was sought.

Mr Regling's intervention therefore confirmed the divergence of institutional interests with regard to

²⁸ Observers have pointed out that this collective clout could rebalance power arrangements in the Council and, by extension, the ESM BoG itself. 'The new alliance, which is becoming increasingly formalised, could take effect at Council level, not only attempting to block proposals from other euro states, but also working towards curbing Franco-German dominance. In June 2018, the Netherlands, an informal spokesman for the group, protested against the Franco-German proposal to set up a separate euro-zone budget' (P. Tokarski and S. Funk, 'Non-Euro Countries in the EU After Brexit: Between Fear of Losing of Political Influence and Euro Accession', *SWP Comment* 2019/C 03 (January 2019), 4).

²⁹ The European Parliament definitely made this connection: '[O]n 6 March 2018 the schedule for modernising EMU was *de facto* put into question after eight—mostly North-European—countries known as New Hanseatic League openly cautioned against a far-reaching development of EMU' (European Parliament, 'Legislative Train, Integration of the ESM into EU Law').

³⁰ K. Regling, 'A European Monetary Fund: For What Purpose?', speech at Euro 50 Group conference, Brussels, 10 April 2018.



EU economic and crisis governance. Unsurprisingly, then, the ESM suggested that it remain its own institution, akin to the European Investment Bank, specifically noting the Mechanism's ability to protect its accountability to its shareholders in this format.

An even more significant proposal in the speech advanced that the ESM be allowed to 'regularly monitor the economic situation in all euro area countries, and not just the current or former programme countries'³¹ for the purposes of swift action in the case of a crisis.

To be clear, the ESM's entire existence has been conditioned on the existence of crisis—the exceptional circumstances where a member state's financial troubles might run so deep as to risk the safety of the entire eurozone. Its original treaty functions reflect this arrangement—the ESM has no effective purpose outside of financing programmes and cannot access member states which have never borrowed from it.³²

In other words, Mr Regling's proposal would provide the ESM with a full-time occupation, stretching its original mandate far beyond crises.

The Meseberg Declaration

By June 2018, the Franco-German Meseberg Declaration on the future steps needed to complete the EMU had sealed the fate of the Commission's proposals, with the declaration acquiescing to all dissenting opinions on the development of the ESM.³³ Incorporating the wish lists of the Hanseatic League and Klaus of Regling in the future ESM was somehow envisaged to take place without duplication or breach

³¹ Ibid.

³² For instance, the ESM's surveillance mechanism, the Early Warning System, only monitors *programme countries'* debt repayment capacity, cannot act on its information independently and has to rely on the Commission to take action through the enhanced surveillance procedure of EU economic governance.

³³ The ESM would remain an intergovernmental instrument founded on the 'underlying principle' of conditionality, managing the future common backstop for the Banking Union, directly participating in the design and monitoring of macroeconomic adjustment programmes, and allowing for the introduction of single-limb collective action clauses (CaCs) as a means of smoothing debt-restructuring operations. It would receive its own analytical capability and access to information to 'assess the overall economic situation in the Member States' during normal times. See Germany and France, 'Meseberg Declaration, Renewing Europe's Promises of Security and Prosperity' (19 June 2018).



of existing Community instruments and within the crisis-specific competences of the ESM Treaty. The integration of the ESM into EU law was mentioned as a formality for an unspecified time in the future, provided its ‘key governance features’—meaning member state control—remained intact.

The Eurogroup

Following the informal political agreement at Meseberg, on 3 December 2018 the Eurogroup proposed its version of reforms, which were much in line with the opposition to the Commission’s package. This approach was wholeheartedly endorsed at the Euro Summit of 14 December, at which the Eurogroup was tasked with preparing a new draft treaty on the ESM.

This created the curious situation in which the ESM—in its Eurogroup iteration—reformed its own treaty. The conflict of interest with inherent in this set-up created harsh optics, but the Eurogroup was protected by the very accountability gap which the Commission’s reforms had sought to repair.

The drafting process was completed in June 2019 and the revised treaty signed on 27 January 2021, ready to undergo national ratification by ESM member states.³⁴

The story of the political and institutional wrangling behind the ESM Reform Treaty is revealing and important. It shines a harsh light on the many divergent interests at play in the management of EU economic and crisis governance. It plainly designates winning and losing sides in the perpetual argument about economic and monetary integration in the Union. It also makes it explicitly clear that this was no ‘missed opportunity’ to fix the scars left by the eurozone crisis, but a political choice and conscious rejection of the possibility to do so.

³⁴ Eurogroup, *Draft Revised Text of the Treaty Establishing the European Stability Mechanism* (14 June 2019).

The Reform Treaty



The following is a brief overview of the ESM Reform Treaty. Not only does its content fail to remedy the ESM's long-standing systemic issues, but it actually worsens these pre-existing conditions because of the further expansion of ESM competences outside of EU law.

The most consequential amendments include the Common Backstop to the Single Resolution Fund, the procedure for precautionary conditioned credit lines (PCCLs), the new rulebook on DSAs connected to collective action clauses (CACs), the ESM's access to European Semester information through a future cooperation agreement with the Commission and the Mechanism's enhanced analytical capabilities. These are discussed below.

The Common Backstop

The most visible and publicised reform of the new ESM Treaty has been the introduction of the Common Backstop to the Banking Union's Single Resolution Fund—emergency financing for the swift resolution of ailing banks. It is expected to become operational in 2022, two years ahead of the original 'schedule'.

The Backstop is a significant step towards completing the European Banking Union and breaking the vicious circle between banks and sovereigns. It is a recognition that the EU is a highly integrated cross-border market for financial and banking services and that the responsibility for financial institutions of a truly European scale belongs at the European level. This could well mean the future difference between a financial crisis and a sovereign debt crisis.

However, in an effort to ensure that full control over Backstop funds is retained by governments, the Eurogroup copied and pasted the highly obstructive voting procedures of the ESM to the Backstop.³⁵ Unanimity voting could subject future decisions on banking bailouts to the private demands of any

³⁵ By contrast, the Commission had proposed that the ESM's managing director be granted the competence to make those decisions single-handedly and thus move the process along in a more expeditious manner.



single eurozone member, which could include purposes entirely unrelated to the Banking Union. The Banking Union is a highly technical, expertocratic framework, generally shielded from political influence by virtue of its subject. Introducing political considerations to its stopgap mechanism—the Backstop—is not without concern.

PCCLs

Another much-publicised reform of the new ESM Treaty is its claim of ‘more effective’ PCCLs.³⁶ These are the most basic and non-intrusive form of financial support the ESM can disburse to troubled states, but only to those who are not too troubled.

Reflecting the low investment risk, precautionary credit lines are extended without conditionality arrangements for structural reforms, that is, without memoranda of understanding.³⁷ In order to qualify for a PCCL a country’s economic and financial situation has to be judged sound based on a number of criteria (debt, market access and financial system health), which remain unchanged in the reformed ESM.³⁸

The novelty comes with the reformed ESM’s rules on member states’ standing with the European Semester for economic governance. The original treaty allowed that governments subject to the preventive or corrective procedures of the Stability and Growth Pact (SGP) and Macroeconomic

³⁶ ESM, ‘ESM Reform’ (n. d.).

³⁷ Streamlining the preliminary stage of the PCCL, the ESM reform stipulates that the recipient country would only sign a letter of intent as opposed to a memorandum of understanding. See ESM, ‘Guideline on Precautionary Financial Assistance’ (n. d.); Eurogroup, ‘Annex III: Eligibility Criteria for Precautionary Financial Assistance’, in Eurogroup, *Draft Revised Text of the Treaty Establishing the European Stability Mechanism* (14 June 2019). Still, the extension of a PCCL is not wholly without conditions. The beneficiary government must show continuous respect for the eligibility criteria, i.e. to sustain sound finances and open its books to monitoring by the Commission and the ECB and, soon enough, the ESM’s own analytical team. As soon as the credit line is drawn on, governments are automatically placed under enhanced surveillance—one of the most invasive monitoring procedures in EU economic governance (see European Parliament and Council Regulation (EU) no. 472/2013).

³⁸ For both the original and the reformed ESM, these include sustainable government debt, a sustainable external position, intact access to markets ‘on reasonable terms’ and a healthy banking system, clarified as the absence of ‘financial sector vulnerabilities’.



Imbalances Procedure (MIP) could still benefit from PCCL aid, provided that they demonstrate ongoing compliance with Semester recommendations.

That is no longer the case under the revised treaty. In the future, PCCL access will be conditioned on a minimum two-year impeccable track record with respect to SGP criteria (deficit, debt benchmark and structural budget balance). Any contact with the Excessive Deficit Procedure—the SGP's corrective arm—becomes an automatic disqualifier. MIP criteria are also to be respected, in so far as governments should demonstrate an 'absence of excessive imbalances'.³⁹

To be clear, a government whose financial standing meets the new threshold for PCCL aid is extremely unlikely to ever need a PCCL. The highly restrictive eligibility criteria severely widen the gap between ESM preventive and corrective financial aid, with the overwhelming majority of member states being automatically placed in the latter category.⁴⁰

Debt sustainability, restructuring and analytical capacities

The ESM Reform Treaty also tries to address the issue of debt restructuring through the introduction of single-limb CACs for eurozone government bonds.⁴¹ These are designed to ensure that negotiations over potential sovereign debt restructuring proceed in a more 'orderly and predictable' manner by reducing the risk that private creditors refuse to participate in restructuring—the so-called hold-out

³⁹ It remains unclear whether that includes the lower threshold Excessive Imbalances Procedure—the preventive arm of the MIP.

⁴⁰ The rest of the ESM's instruments are characterised by strict conditionality and invasive interference, either through enhanced surveillance procedures (for precautionary credit lines) or full macroeconomic adjustment programmes (for loans).

⁴¹ 'Collective action clauses are clauses in bond terms that allow changes to the terms of those bonds to be made subject to a vote by the holders of those bonds. If a majority approves the change, it becomes effective for all the bonds.' Double-limb CACs 'require two separate majorities to approve a change in bond terms: one at the level of each "series" and one at the level of all "series" combined. This means that it is more difficult to achieve a majority that would make it possible to restructure a country's sovereign debt, compared to a single-limb CAC' (ESM, 'Explainer on ESM Reform and Revisions to the ESM Treaty', Press Release, 24 June 2019).



problem.⁴² Debt restructuring, however, still depends on the outcome of DSAs. The reformed treaty does not address the problematic ESM voting arrangements on this matter. It actually complicates the DSA procedure further by introducing yet another component to the analysis.

In the future, the details of ESM financial aid programmes and debt restructuring will depend on the outcomes of a DSA *and* the newly minted repayment capacity assessment—a procedural institutionalisation of ESM shareholder interests.⁴³ The analyses are supposed to be carried out in tandem by the Commission, in liaison with the ECB and the ESM, and are generally expected to arrive at the same conclusions.

However, the Reform Treaty recognises that the ESM and the EU are beasts of different natures, protecting different institutional interests.⁴⁴ Should these sometimes conflicting responsibilities result in dissenting views, the new set-up enables each institution to default to a uniquely assigned responsibility—the Commission is to limit its assessment to debt sustainability (DSA), while the ESM focuses on debt repayment (through the repayment capacity assessment).⁴⁵ These potentially conflicting reports will then inform a proposal by the managing director of the ESM to the BoG for a final decision.⁴⁶

The division of labour between institutions cannot be over-emphasised. The Reform Treaty clearly takes the view that EU institutions cannot be trusted to protect the interests of ESM shareholders.⁴⁷

It is not clear exactly how these new provisions would impact the possibility of debt restructuring in the EU or the efficiency of the ESM. Formalising dissenting opinions is certainly an exercise in

⁴² C. Fang, J. Schumacher and C. Trebesch, *Restructuring Sovereign Bonds: Holdouts, Haircuts and the Effectiveness of CACs*, ECB Working Paper Series no. 2366 (January 2020).

⁴³ Amendment to art 13.1(b) ESM as per the ESM Reform Treaty.

⁴⁴ Contrary to the Commission's mandate to safeguard the interests of the Union, the ESM is explicitly said to perform 'its analysis and assessment *from the perspective of a lender*' (European Commission and ESM, 'Joint Position on Future Cooperation between the European Commission and the European Stability Mechanism' (14 November 2018), Section 3 (emphasis added)).

⁴⁵ Recital 12A ESM Reform Treaty; see also, ESM, 'ESM Treaty Reform – Explainer' (2020).

⁴⁶ Art 13.2 ESM Reform Treaty; Recital 12-12B ESM Reform Treaty; European Commission and ESM, 'Joint Position on Future Cooperation between the European Commission and the European Stability Mechanism'.

⁴⁷ That is, that the Commission or the ECB may be more inclined to give a favourable debt analysis or too easily forgive a debt owed to third parties, i.e. the ESM shareholders.



institutional empowerment. This, in turn, could lead to greater institutional accountability, whenever information is made publicly available. But ultimately the new procedure also politicises the process. When experts cannot agree to compromise on shared recommendations, the balancing exercise on these particularly technocratic matters is moved to the political arena of the ESM BoG—the eurozone ministers for economy and finance—with its highly restrictive voting arrangements. That cannot be a welcome development.

New competences

With the Reform Treaty, the ESM is set to grow exponentially with new autonomous analytical capabilities and competences. It will be involved in the negotiation, design and oversight of programme conditionality; be able to join monitoring missions to member states; and conduct independent analyses of data for the appraisal of financial risk, liquidity needs and debt sustainability.⁴⁸ The ESM is also to begin signing the conditionality programme memoranda of understanding alongside the Commission, although it is unclear to what legal effect—if any—since it remains outside the reach of EU law. Most importantly, all these powers will remain active in economic and financial ‘peacetime’.

Peacetime powers

By far the most consequential change in the ESM Reform Treaty is the one least noticed, least understood, most fluid and with the greatest potential for further development. It is the new role for the Mechanism outside financial aid programmes, outside crises.

⁴⁸ European Commission and ESM, ‘Joint Position on Future Cooperation between the European Commission and the European Stability Mechanism’. The agreement will enter into force at the same time as the amendments to the ESM Treaty.



Article 3.1 of the ESM Reform Treaty presents the reformed—and significantly expanded—purpose of the ESM. Apart from providing imminent-crisis stability support, the Mechanism may also,

where relevant in order to internally prepare and enable it to appropriately and in a timely manner pursue the tasks conferred on it by this Treaty . . . follow and assess the macroeconomic and financial situation of its Members including the sustainability of their public debt and carry out analysis of relevant information and data. To this end, the Managing Director shall collaborate with the European Commission and the ECB to ensure full consistency with the framework for economic policy coordination provided for in the TFEU.⁴⁹

The new competences are slightly clarified in an agreement on future cooperation between the Commission and the ESM that is to be annexed to the Reform Treaty. This agreement provides the ESM with access to the Commission's monitoring missions to member states in the absence of financial aid.⁵⁰ Furthermore, the two institutions have agreed on a regular exchange of information: 'Based on reciprocity, the Commission and the ESM will share data, analyses and assessments while respecting applicable Union law'⁵¹ and 'would meet informally to share assessments and analyses pertaining to their respective competences as well as to discuss and assess macro-financial risks.'⁵²

The most obvious and logical reason behind these peacetime powers is to give the Mechanism a full-time job beyond financial crises and the resolution of outstanding debts. These new competences also mark a significant shift in the institutional identity and role of the ESM. Just how significant, however, remains unclear due to the open-ended character of the legal provisions instituting the new powers. In turn, these give rise to a multitude of possibilities, leaving the future regime lacking legal clarity and judicial protection.⁵³

⁴⁹ Art 3.1, ESM Reform Treaty.

⁵⁰ Ibid., Section 1, 1.

⁵¹ Ibid., Section 7, 4.

⁵² Ibid., Section 1, 1.

⁵³ Clarity of purpose and consequences tends to be a fundamental characteristic of good laws.



Peacetime powers: questions

First, it is not clear what the future ESM's macroeconomic and financial assessment functions will consist of. But additional questions also arise:

- What are the ESM's governance procedures on the conduct of peacetime analytical capabilities?
- How will ESM analyses relate to and differ from those carried out by the Commission and the ECB, in order to avoid a clash of competences and ensure full consistency with the EU treaties?
- Will the results of ESM analyses translate into action vis-à-vis EU member states and, if so, how?
- Second, we must address the ESM's future relationship with EU economic governance.
- Which member state budgetary and financial health indicators trigger ESM surveillance or warrant its access to monitoring missions conducted outside of financial aid programmes?
- Is the ESM's right of initiative and right to access automatic or assessed on a case-by-case basis?
- Could triggering ESM monitoring lead to a self-fulfilling prophecy, unnerving markets and generating the circumstances for financial turmoil?
- What is the confidentiality regime covering the ESM's concerns, analyses or involvement in missions to governments which have not received financial aid?
- What are the rights and obligations of either the Commission or the ESM to request, share or act on information under the Agreement on Future Cooperation?

Lastly, in assessing this future framework of peacetime competences and cross-legal cooperation, we must not forget that the ESM is—and will remain—an ‘international financial institution’ with a principal responsibility towards its shareholders. And it is for the purpose of protecting these interests



that the ESM conducts its analyses ‘from the perspective of a lender’.⁵⁴

- But what does a ‘creditor approach’ mean outside the context of financial crises, in the absence of ESM debt or financial turmoil?⁵⁵
- What are shareholder interests in the absence of issued credit?
- In other words, how does the ‘perspective of a lender’ translate into the perspective of a *prospective* lender?

One conclusion seems unavoidable—ESM shareholder interests in the absence of debt are simply eurozone government interests. That is, the ESM Reform Treaty’s peacetime powers are likely to create an intergovernmental centre of gravity pulling away at the EU treaty architecture. Its influence will depend on the intra-institutional dynamics of the ESM—the balance between its technocratic identity and the political priorities of its shareholders.

Peacetime powers: inappropriate liaisons

But why would any of these peacetime powers matter if the ESM seems to have no authority over governments that have not made use of its funding?

Not unlike disagreements over government debt sustainability during the negotiation of ESM financial aid programmes, there is the potential for interinstitutional disagreements over the budgetary or economic position of a member state under regular Semester surveillance. For instance, being a crisis-focused risk-averse body, the ESM might favour harsher corrective measures than the Commission is willing to recommend within the Semester framework.

This is the point at which the ESM’s potential participation in monitoring missions (which determine the intensification and conditionality of the European Semester procedures) and the information

⁵⁴ See note 44 above; European Commission and ESM, ‘Joint Position on Future Cooperation between the European Commission and the European Stability Mechanism’, Section 3.

⁵⁵ Recital 5(b), ESM Reform Treaty.



exchange channel with the Commission could come into play.⁵⁶ The ESM's mere interest in any particular member state—whether through missions or analytics—could trigger a political alarm in the Council and expectations of a tougher response by the Commission.

This dynamic would be a significant departure from the current state of affairs, potentially impacting the Commission's lead and independence in these matters. Moreover, Commission proposals to the Council on a regular economic governance procedure could thus come to consider *a priori* the Council's 'point of view'.

This means the ESM peacetime capabilities could produce legal consequences outside the regime they were born of by affecting matters of EU law. The informality of it all would surely obscure the legal and procedural boundaries between regular and crisis governance in the Union and between the powers exercised within either the EU or the ESM Treaty frameworks.

⁵⁶ European Commission and ESM, 'Joint Position on Future Cooperation between the European Commission and the European Stability Mechanism', Sections 7,4 and 1,1.

**EMU
ideology**



Theorising the EMU

The bottom line in all this is, of course, ideological. The ESM's institutional logic goes far beyond its role as LLR and its fiduciary responsibility to its shareholders. Rather, at its core, it is a manifestation of the politico-economic ideology which laid the foundations for the EMU with the Maastricht Treaty in 1992.

Three decades ago, governments bargained the future of the EU on an experimental and highly unstable governance framework riddled with assumptions. In an effort to avoid establishing a real fiscal union, in order to prevent surrendering further sovereignty and the cross-border transfer of funds, member states formalised within the treaties a synthetic equivalent. It was thought that if all governments coordinated their efforts and conducted their fiscal affairs within the boundaries of the SGP's budgetary rulebook, their economies would act 'as one', and thus provide a sufficient substitute for a real fiscal union. In the global economic and monetary context of the time, this approach instituted the functional need and moral superiority of fiscal prudence. The ultra-independent ECB, fixated on securing price stability and countering inflationary pressures, provided an added incentive for compliance. The now infamous EU treaty bailout prohibitions (arts. 123 and 125 TFEU) were designed to act as the ultimate firewall in this regard—enforcing fiscal discipline with a firm promise that there would be no debt sharing.

The Maastricht Treaty, then, was a scheme to have one's cake and eat it too, allowing member states to reap the benefits of the common market and deepened integration without sharing in the risks of an open economy. It was a temporary solution to bring the EMU to life until EU countries were fully



prepared to embrace solidarity in a real political union.⁵⁷

Practicing the EMU

Unfortunately, the theory behind the EMU did not translate well into practice. The sovereign debt crisis was but the harshest manifestation of the underlying conditions. Economic convergence had remained a theoretical conjecture, the budgetary rulebook was all but fully disregarded and when push came to shove, member states discovered that the cost of a sovereign default, demanded by the bailout prohibitions, was simply too high for a union so deeply integrated.

In a certain sense, the creation of the ESM in the midst of it all represented member states' steadfast commitment to the principles of the Maastricht compromise, even as these principles fell apart around them. If funds had to cross borders, the structure of the Mechanism allowed governments direct control over the process: ownership through shares, risk management of the investment, full repayment guarantees and overall oversight. Above and beyond this, disciplinary conditionality served as a reminder of a valuable lesson—the moral (and very material) superiority of fiscal prudence.

Granting control of these matters to a European institution would have been tantamount to surrendering the hard-fought fiscal freedoms of Maastricht. This political stance had a convenient legal iteration in the sense that establishing the ESM outside the bounds of EU law served to circumvent the bailout firewalls. And so, ironically, member states' commitment to the original EMU compromise had legally forced them outside of it.

⁵⁷ The approaches to achieve this end differed. The German delegation was convinced that Europe first needed political trust for a real fiscal union before it could undergo the single currency project; the French, on the other hand, rather hoped the deepened integration brought about by the demands of a single currency would ensure fiscal alignment, with which would come a common European political identity. On the origins of EMU, see the Delors Report for proposals on EMU, which laid the expert technical foundations for the Maastricht negotiations (Committee for the Study of Economic and Monetary Union, *Report on Economic and Monetary Union in the European Community* (Brussels, 17 April 1989); Committee for the Study of Economic and Monetary Union, *Report on Economic and Monetary Union in the European Community, Collection of Papers Submitted to the Committee for the Study of Economic and Monetary Union* (Brussels, 1989)). On the historical importance of the Delors Process and all the technical options for creating EMU discussed therein, see K. Dyson and I. Maes (eds.) *Architects of the Euro—Intellectuals in the Making of European Monetary Union* (Oxford: OUP, 2016).



The times they are a-changin'

If the euro crisis saw the Commission, the ECB and the member states agree on a collective response to reinforce the Maastricht contract, this was to a large extent due to the global economic context of the time, which still underpinned the economic logic of their approach.⁵⁸ By 2017, when the Commission called for the completion of the EMU and the integration of the ESM, conditions both inside and outside the EU had changed. Inflationary pressures had given way to a stubborn recession that stifled growth and interest rates nearing the zero bound eroded the logic of debt politics.⁵⁹ The forced return to fiscal prudence through austerity had proven itself an acutely defective approach to economic growth in such conditions.⁶⁰ In other words, the fundamentally altered global monetary and fiscal paradigm and increasingly divergent member state economies could no longer sustain the Maastricht scheme for an asymmetric EMU.

This environment created extreme pressure to adjust the EU's political economy towards greater risk sharing and solidarity in order to balance out the system on the supranational level. Simply put, economic and financial integration had proceeded far beyond what the treaty firewalls agreed at Maastricht could sustain or austerity economics could fix.⁶¹

⁵⁸ In this regard, the ESM's intergovernmental genesis was a convenient solution to a pressing problem; where the powers of LLR were found made little difference as long as everyone agreed on the pursued aims.

⁵⁹ This is also evidenced by the shift in ECB policy to unconventional monetary policy and aggressive quantitative easing in an effort to stimulate the economy. For a short and thorough explanation of the fundamental changes in global central banking, see A. Tooze, 'The World's Central Banks Are Starting to Experiment. But What Comes Next?', *The Guardian*, 9 Sept 2020.

⁶⁰ In the EU this caused more harm than good, only exacerbating the economic divergences between member states and extracting a heavy political price with a struggling electorate grasping at populist straws. On the economic and political consequences of the sovereign debt crisis, see A. Mody, *EuroTragedy: A Drama in Nine Acts* (New York: OUP 2018), 391–436.

⁶¹ The crisis had showcased the extent of member states' exposure to each other's debts in spite of the best efforts of the system to avoid this. Simply put, the markets and integrated financial framework refused to acknowledge the synthetic firewalls erected by the EU treaties, treated the Union as fully integrated and hedged their bets on a bailout, knowing sovereign defaults would be too costly for the collective to allow.



The Commission's plan for completing the EMU sought to address these conditions.⁶² But, as we have seen, a sufficiently influential group of member states equated the introduction of minimum standards of solidarity with exposure to unnecessary liability.⁶³ In their refusal to let go of the Maastricht worldview, these governments misjudged the logic of economic reality for the political sentiment of voluntary integration. Their campaign to salvage the economic order of the Maastricht compromise has resulted in the ESM Reform Treaty.

⁶² To this end the Commission's EMU reform package proposed new instruments to balance out growing divergences and mutual insurance schemes against member states' growing exposure to risk—the Common Backstop to the Single Resolution Fund, the future ESM which promised to weigh shareholders' interests with those of the collective union, and a novel budgetary support facility for greater structural reform assistance with a stabilisation function across national borders. These are outlined in the rest of the Commission's December 2017 package proposal (COM (2017) 821-827 (final)).

⁶³ Hanseatic League, 'Position EMU Denmark Estonia Finland Ireland Latvia Lithuania the Netherlands and Sweden', para. 3.



Conclusion



The history of the ESM Reform Treaty

Distrust

The legislative history of the ESM Reform Treaty indicates troubling levels of distrust between EU institutions and member states, and—as a result—between EU institutions and the ESM. These dynamics can be ascribed to a divergence of interests between the parties involved, whether based on their institutional mandate or on political considerations.

The increasing economic pressure for solidarity in the collective Union format seems to have created a growing schism between governments and their own creation—the EU. Against this backdrop, reform of the ESM has served as an alternative arrangement, enabling member states to avoid surrendering further competences to the EU. This, in turn, has created a second centre of gravity for governance of the EMU outside of the EMU, especially through the ESM’s novel peacetime capabilities. The new framework has displaced significant powers exercised by eurozone ministers of economy and finance outside the legal and democratic protections of the EU treaties.⁶⁴ If left unchecked, the reformed Mechanism could become an institutional avatar for intergovernmentalism in the EU, with powers far surpassing what the Council is capable of accomplishing for itself within the EU’s legal framework.⁶⁵ The potential damage to the functionality and legitimacy of EU economic and crisis governance will depend on the prudent exercise of EU treaty protections.

⁶⁴ The Eurogroup is not an EU body. This was confirmed by the CJEU in Case C-597/18 P, *Council v K. Chrysostomides & Co. and Others* [2020] ECLI:EU:C:2020:1028, paras. 84–90. As far as the ESM BoG format is concerned, the procedures of the original ESM Treaty hardly provide for much justiciability in relation to EU law.

⁶⁵ In a report on the ESM from before the beginning of the reform process, Transparency International analysts observe analogous developments at play. See C. Ban and L. Seabrooke, *From Crisis to Stability: How to Make the European Stability Mechanism Transparent and Accountable*, Transparency International (2017), 19–22.



Content of the ESM Reform Treaty

The ESM Reform Treaty itself leaves much to be desired. We can already identify the early costs of the new arrangements: (i) the ESM Reform Treaty does not resolve outstanding issues from the original ESM framework, (ii) it creates new problems related to its expanded powers, and (iii) it remains an extremely limited instrument with which to properly manage future crises.

Old problems

First, the ESM Reform Treaty does not resolve the outstanding issues with the original ESM governance framework or its relationship to EU law, including

- the lack of accountability in the alarming nexus between the ESM and the Eurogroup, which acts as a decision-making black hole;
- the ESM's unanimity voting procedure, which is ill-suited to the demands of swift crisis resolution and riddled with conflicts of interest;
- the lack of justiciability of ESM actions, which forces the European Commission to take on the liability of balancing the primary norms of Union law with the primary interests of the ESM; and
- the damage done to 'market discipline' by removing the risk of sovereign default and substantially decreasing the chances of debt restructuring, because ESM shareholder interests are inextricably linked to those of the market.

New problems

Second, the expanded powers of the Mechanism and its continued existence outside EU law



- create a second centre of gravity in the EU constellation, obscuring the hierarchies and protections of EU law and obstructing much-needed progress in the EMU;
- erode competences already in EU custody;
- diminish EU authority and the collective ability to act within the treaties, setting a dangerous precedent for parallel legal frameworks whenever further integration looks politically unacceptable;
- will create further procedural, governance and legal uncertainty for the future, likely to be acutely felt during the next episode of turbulent financial events; and
- endorse the dangerous pretence that the EMU project can be sustained without shared risk and solidarity.

Future limits

However, perhaps the most critical issue with the ESM is just how limited it is.

The ESM is not a flexible instrument. It was legally designed to imagine one scenario—that of the sovereign debt crisis, which required disciplinary conditionality in exchange for financial aid. It is also the case that, by the same legal token that allows its existence in spite of the EU treaties' bailout prohibitions, the ESM can only provide one kind of stability support: punitive.⁶⁶

This approach may have made sense as an ad hoc solution to the very specific circumstances of a decade ago. However, it would be careless to insist that it can resolve the multitude of difficulties that might befall the eurozone in the future, especially in the context of the fundamentally changed global economic paradigm.

The ESM's limited capacity to respond to the financial needs brought about by the global health

⁶⁶ CJEU, Case C 370/12, *Pringle*. The obvious presumption is that falling on hard times—whether caused by irresponsible banks, markets or public spending—is the exclusive responsibility of governments, which must have somehow brought the problem on themselves.



pandemic speaks loudly to this point. Not only have governments shied away from any association with the Mechanism,⁶⁷ but the legality of altering the precautionary credit line facility to provide *non-conditioned* aid for member states' health care expenses might soon become subject to legal contestation in German courts.⁶⁸

There is also another argument against outsourcing LLR capabilities exclusively to an institution so limited and legally captive to its shareholders as the ESM. The ultimate criterion for LLR financial aid is to secure eurozone stability. That much has been widely agreed upon. However, the definition of this stability or the means of achieving it could easily prove a point of contention between the stakeholders. For instance, consider the most recent disputes over the unconditioned precautionary aid offered by the ESM to pandemic-stricken member states.

The experience of the sovereign debt crisis has created a misleading implicit assumption that the Union and the ESM would always agree in this regard. We must remember that these are institutions with widely divergent mandates and policy interests. They aligned during the eurozone crisis because the Commission, ECB and ESM all needed governments to comply with fiscal discipline. But they did so for very different reasons.

The Commission pushed policies that would limit the alarming levels of economic divergence across the Union, since massive public debt was identified as a main cause of the crisis. This was in line with its mandate for fiscal and economic policy coordination. The ECB also advocated for fiscal austerity as a solution to economic divergence, but did so in the interest of its monetary policy transmission

⁶⁷ At the time of writing, the ESM has still not received any official requests for its Pandemic Programme. During a recent press conference, ESM Managing Director Klaus Regling claimed that use of the facility need not affect the markets' perception of the stability of the eurozone and has therefore served its purpose, even if it has also shown that member states find association with the Mechanism toxic. See K. Regling, 'Eurogroup Video Press Conference' (30 November 2020).

⁶⁸ This is because, in order for all member states to qualify as eligible, the ESM has made available its enhanced conditions credit line, which should come with conditionality arrangements for structural reforms and enhanced surveillance. What is more, to ensure that the aid is readily available in a timely manner, the Commission has pre-certified the financial health of all eurozone member states in order to deem them eligible. It is not clear how an actual request for ESM Pandemic Crisis Support would proceed should economic conditions for certain members change in the meantime. For general information, see ESM, 'ESM Pandemic Crisis Support: Explainer, Timeline and Documents' (6 July 2020). For an overview of the risk of legal battles in the German courts, see D. Marsh, 'German Court Litigants Prepare Fresh Skirmishes', *Official Monetary and Financial Institutions Forums*, 12 August 2020.



mechanism and because its single monetary policy is specifically designed to work in the context of a single (consolidated) economic policy across eurozone capitals. The ESM, on the other hand, was interested in enforcing structural reforms through conditionality arrangements, because austerity literally legalised financial aid and helped ensure that borrowing governments were capable of repaying their ESM debt. Moreover, this joint EU approach represented the dominant economic expertise of the time.

The next crisis may not be the same. The changing global economic paradigm has already altered key features of the approach. We cannot assume that the ESM's mandate to act in the best interests of its shareholders would amount to acting in the best interests of the EU as a whole. In fact, the struggles over EMU and ESM reform of the last couple of years and the distrust which has infiltrated the relationship between EU bodies and the Mechanism speak to the exact opposite.

Recommendations



The ESM Reform Treaty leaves a number of issues unaddressed. Of immediate concern are the expectations of how the reformed framework will operate for crisis management and prevention, specifically with regard to the ambiguity of its novel competences. The long-term outlook has to consider further reform recommendations.

Immediate concerns: ESM Reform Treaty

Significant questions remain as to the extent and legal consequences of the Reformed ESM's future operations, specifically its peacetime powers. Their unsettled parameters leave a multitude of possibilities as to how the Mechanism may choose to exercise its new role and position itself vis-à-vis the EU framework of economic and monetary governance.

The peacetime powers lay the foundations for an exercise in institution building. In its original iteration, the ESM has very little to do in the absence of financial crises. Therefore, it is not far-fetched to expect an activist policy stance and the risk of an overzealous commitment to identifying and preventing crises. Simply put, the risk is that when all you have is a hammer, everything will look like a nail.

These institutional impulses could be managed (i) by establishing clarity about the nature and extent of the ESM's future competences outside of financial aid, and (ii) through EU secondary legislation. To this end, an immediate concern for stakeholders should be to address the questions outlined in Section 4.5.1. This process should begin during the ratification procedures for the Reform Treaty, which would expose its contents to the national democratic process of each eurozone government. In fear of national vetoes, this would be a potent and useful opportunity to explore outstanding questions before endorsing this new chapter in EMU history.⁶⁹

⁶⁹ As per art. 48 ESM Reform Treaty, the treaty will come into force with no less than 90% of shareholder capital on board. This means countries will need to vote en bloc or hold at least 10% shareholder capital themselves in order to veto the entire process.



Furthermore, these competences could be substantially amplified or restrained through EU secondary legislation. This will be the most likely future forum for political or institutional activism vis-à-vis the reformed ESM.

Details are most likely to come through amendments to existing Council acts covering the European Semester, specifically Regulation (EU) no. 472/2013 on the strengthening of economic and budgetary surveillance of member states in the euro area experiencing or threatened with serious difficulties with respect to their financial stability, and even through novel legislation. A focal point for development would be the ‘Joint Position on Future Cooperation Between the European Commission and the European Stability Mechanism’, which has remained in stasis since being made public in November 2018. Lastly, we must consider that these developments would be continually conditioned by the nature of the working relationship between the Commission and the ESM and, just as likely, by the political considerations of the time.

Long-term concerns: reforming the ESM Reform Treaty

The long-term prospects for the ESM promise more reforms.⁷⁰ As the list of outstanding problems in the concluding section of this paper clearly demonstrates, the Mechanism simply is not a finished product.

There are three main themes to address in future reforms—instrument rigidity, paralysing politicisation and lack of justiciability. These could all be pursued either under the ESM’s current legal status or by

⁷⁰ In this sense, the Reform Treaty has been a true ‘failing forward’ moment for EU integration—the cycle of crises met by lowest common denominator intergovernmental solutions, themselves leading to deficiencies and those leading to more crises. See E. Jones, R. D. Kelemen and S. Meunier, ‘Failing Forward? The Euro Crisis and the Incomplete Nature of European Integration’, *Comparative Political Studies* 49/7 (2015), 1010–34.



bringing the Mechanism under the EU treaties. Either way, any future steps will have to navigate the complex dynamics of institutional and political distrust which have defined the reform process.

Reforms under public international law

In terms of *rigidity*, in order for the ESM to fulfil its true function as a crisis-management mechanism, it must be able to ‘imagine’ eurozone stability through more than conditionality. This flexibility ought to be reflected in its treaty. The tweak could come by revisiting the CJEU’s ruling on the ESM’s legality in *Pringle*.⁷¹ There, the Court allowed the existence of a financial aid mechanism in spite of the bailout prohibition (art. 125 TFEU) on the condition that any aid should induce member states to pursue a ‘sound budgetary policy’.⁷²

However, as we have seen, the global economic paradigm is shifting and EU bodies are attempting to respond accordingly. To this end, the ECB’s Strategy Review is currently mapping out a significant overhaul of the way it conducts monetary policy.⁷³ Meanwhile, with the rules of the SGP suspended for the time being, the Commission is preparing to revisit the economic governance rulebook, and might well arrive at conclusions far removed from the logic of Maastricht and its intensified iteration dating from after the euro crisis.⁷⁴

In other words, the very definition of a ‘sound budgetary policy’ is undergoing a review. This might just be the legal opening needed for the ESM to embrace flexibility without the need for EU treaty reform. For instance, instead of promising to grant financial assistance ‘subject to strict conditionality’,⁷⁵ it could do so subject to supporting the ‘sound budgetary policy’ of eurozone member states and the stability of the EMU.

The *politicisation* of the ESM is largely owed to its governance structure, which puts member state

⁷¹ CJEU, Case C 370/12, *Pringle v Government of Ireland* [2012] ECLI:EU:C:2012:756.

⁷² Ibid, paras. 133–7.

⁷³ The results are due by September 2021. For an overview, see ECB, ‘ECB Strategy Review’ (n. d.).

⁷⁴ For an overview, see J. Pisani-Ferry, ‘When Facts Change, Change the Pact’, *Bruegel*, 1 May 2019.

⁷⁵ Recital 2, ESM Reform Treaty.



representatives—the ministers for economy and finance—at the core of decision-making. As we have seen, this makes for an often cumbersome and slow procedure, plagued by any individual government's concerns. Furthermore, this is the cause of serious conflicts of interest with respect to voting on DSAs or the dual role of the Eurogroup. Lastly, this governance structure reflects the primacy of shareholder interests, which might one day be the exact opposite of what eurozone stability actually needs.

Reforming this set-up does not have to be a traumatic political experience and could develop in two phases. The last decade—and its new peacetime capabilities—have seen the ESM grow into and develop its own institutional identity based on technocratic expertise. Trusting the maturity and experience of the Mechanism under some form of its own supervision would be a lesser leap of faith for member states than awarding these decision-making powers to the European Commission.

Such reforms would call for a substantial revision of the ESM's governance structure. This could still be a bearable adjustment, as long as the ESM Treaty mandates the principal protection of shareholder interests for the duration of phase one, the depoliticisation of the ESM. With enough trust, time and economic stability, phase two could eventually see the Mechanism commit itself to the interests of the EU project, instead of its shareholders.

When it comes to the matters of *justiciability* or the protection of fundamental rights, we must acknowledge that there is absolutely nothing preventing the ESM's signing parties—the eurozone governments—from committing the activities of the Mechanism to respecting the European Charter on Fundamental Rights and submitting it to the authority of the European courts. This issue has plagued the Mechanism's legitimacy and greatly exacerbated the political backlash to financial aid programmes in troubled member states, which in turn has worsened compliance. It would be highly advisable to subject the ESM's operations to the legitimating standards of judicial review and rights protections. Persisting with the current arrangements risks further stigmatising the Mechanism, as has already been shown with member states' extreme reluctance to engage with the ESM on pandemic crisis aid.



Reforms under EU law

Whatever decisions may be taken on the future of the ESM under public international law, they cannot ignore the unfolding experience of the EU's fiscal pandemic response with Next Generation EU. The current economic turmoil has underscored the need for and introduced the possibility of a permanent facility of shared fiscal capacity capable of providing flexible (non-conditional) financial aid under the stewardship of the Commission. The future of such an instrument and that of the ESM are inextricably linked. The EU should not allow a cacophony of parallel financial facilities under parallel legal and governance frameworks.

Ultimately, if there is no political capital to establish emergency fiscal resources under EU law, there would be even more pressure on the ESM to undergo another round of far-reaching reforms in the interests of flexibility, justiciability and depoliticisation. However, if Next Generation EU proves a positive exercise, the EU establishment should look to capitalise on the newfound trust to consolidate its economic *and* crisis governance capacities under a single flag—a certain blue one with 12 gold stars.

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On 27 January 2021 the member governments of the European Stability Mechanism (ESM) signed the Agreement Amending the ESM Treaty, instituting long-awaited reforms to the EU's crisis-management and financial-aid mechanism. The ESM was never perfect. Set up outside the EU treaty framework, it suffered from acute accountability and legitimacy issues and, being directly controlled by eurozone governments, its procedures were subject to cumbersome voting arrangements and conflicts of interest. Finally, with its inception in the throes of the eurozone crisis, it was committed to a single rigid approach based on conditionality.

This paper finds that the ESM Reform Treaty not only fails to address the outstanding issues in the original ESM framework, but exacerbates the status quo by further empowering the Mechanism outside the legal framework of the EU treaties.

Future reforms are not just advisable, they are a functional necessity. A compromise solution could see the ESM become its own independent technocratic institution, equally removed from the political influence of governments and the reach of the Commission. Introducing flexibility in its strict conditionality could be a matter of reinterpreting the meaning of 'sound budgetary policy' from the Court of Justice of the European Union's ruling in Pringle. Lastly, in matters of justiciability and the protection of fundamental rights, nothing prevents ESM governments from committing the activities of the Mechanism to the European Charter on Fundamental Rights or the authority of the European courts, should they wish to do so.



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