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European integration and the role of the ESM

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- On 15 December EU leaders will discuss integration. One proposal that is mentioned in the debates in France and Germany is a repurposing of the ESM as a "European Monetary Fund". Using a Q&A format, we consider what reforms might mean for the euro area bailout fund.
- Visions of economic integration differ. France wants additional stabilization tools and risk-sharing while Germany wants better supervision of fiscal rules and market discipline. If the ESM is the vehicle through which these visions are implemented, the former would see the ESM's responsibilities and tools expand markedly and the latter would be more limited, with new responsibilities for preventive crisis monitoring coupled with tougher investor conditionality in the event of intervention.
- Compromise and conditionality characterize Europe's progress towards closer integration. The extent to which a reformed ESM converges to the more expansive vision will be a function of (a) the importance Europe attaches to supporting Macron's policy agenda, (b) the ESM being the right vehicle for integration, (c) the reinterpretation of the ESM as a tool to address the sovereign-banking nexus and not just stressed sovereigns and (d) the role market discipline will play in conditionality.
- The ESM role in completing banking union should not be underestimated. Cross-border banking and capital flows would be consistent with both the French and German visions of integration. An ESM credit line for the EUR55bn Single Resolution Fund (SRF) has been agreed in principle but implementation has so far been blocked by legacy banking issues.
- EU leaders say completing banking union should be the next step. It should be growth-positive, but rushing the correction of legacy risks could entail adjustment costs. If banking union is slow, progress on general integration will also be slow. That would clash with the time-limited opportunity to act to strengthen Europe presented by Merkel-Macron.
- This means pressure for compromises within the ESM reform discussions and we see some convergence toward the more expansive visions of the ESM as likely. The risk is market-unfriendly conditionality and overall we expect ESM reform to be modest in scale and scope. Rather than economics, the more significant signals on European integration could come through common migration and security/defence policies.

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Key Economic Forecasts

Figure 2: Economic Forecasts

	Real GDP % growth[b]			CPI % growth[c]			Current a/c % GDP[d]			Fiscal balance % GDP		
	2016	2017F	2018F	2016	2017F	2018F	2016	2017F	2018F	2016	2017F	2018F
Euroland (top-down)	1.8	2.2	2.0	0.2	1.5	1.4	3.3	3.0	2.6	-1.5	-1.3	-1.3
Germany[b]	1.9	1.9	1.8	0.4	1.6	1.6	8.4	8.0	7.8	0.8	0.5	0.2
France	1.1	1.7	1.7	0.3	1.1	1.1	-0.9	-0.5	-0.6	-3.4	-3.0	-2.7
Italy[b]	0.9	1.5	1.2	-0.1	1.4	1.2	2.7	2.6	2.3	-2.5	-2.3	-2.2
Spain	3.3	3.0	2.5	-0.3	2.0	1.5	1.9	1.8	1.7	-4.5	-3.4	-2.5
Netherlands	2.2	3.2	3.3	0.1	1.2	1.3	9.0	10.2	10.2	0.4	1.1	0.5
Belgium	1.5	1.9	2.0	1.8	2.2	1.7	0.1	0.0	0.5	-2.5	-2.1	-1.8
Austria	1.6	2.4	1.9	1.0	2.1	1.8	2.1	2.0	2.3	-1.6	-1.0	-0.8
Finland	1.9	2.5	1.9	0.4	0.9	1.2	-1.4	-0.5	0.0	-1.7	-0.8	-0.4
Greece	0.0	1.5	2.7	0.0	1.2	0.8	-1.1	-0.5	0.0	0.5	-2.0	-1.5
Portugal	1.5	2.6	1.7	0.6	1.4	1.4	0.9	0.4	0.4	-2.0	-1.6	-1.4
Ireland	5.1	4.5	3.7	-0.2	0.3	1.1	3.3	4.5	3.5	-0.7	0.0	0.0
Uk[h]	1.8	1.6	1.0	0.6	2.6	2.7	-4.4	-3.8	-3.5	-2.9	-2.9	-2.6
Sweden	3.1	2.7	2.4	1.0	1.6	1.8	4.7	4.8	4.8	1.9	0.7	0.7
Denmark	1.7	1.6	1.8	0.2	1.2	1.4	6.5	7.5	7.3	-1.2	-1.2	-0.7
Norway	0.7	1.3	1.9	3.6	2.0	2.0	4.4	6.1	6.4	3.0	3.6	3.8
Switzerland	1.4	1.5	1.9	-0.4	0.3	0.3	10.7	11.2	11.0	0.2	0.5	0.5
Poland	2.7	3.9	3.4	-0.6	1.8	1.9	-0.3	-1.0	-1.1	-2.5	-2.7	-2.9
Hungary	2.0	3.8	3.5	0.4	2.3	2.6	6.1	3.1	2.5	-1.8	-2.3	-2.4
Czech Republic	2.5	3.8	3.0	0.7	2.4	2.2	1.1	1.3	1.0	0.6	0.3	0.0
US	1.5	2.1	2.4	1.3	2.2	2.0	-2.6	-2.9	-3.2	-3.1	-3.6	-2.8
China	6.7	6.7	6.3	2.0	1.7	2.7	1.8	1.3	1.1	-3.8	-4.0	-4.0
Japan	1.0	1.5	0.7	-0.1	0.3	0.4	3.7	4.0	4.2	-3.5	-3.5	-3.1
Advanced Economies	1.6	2.0	2.0	0.7	1.7	1.6						
Emerging Markets	4.2	4.7	4.9	6.2	7.8	16.8						
World[e]	3.1	3.6	3.7	3.9	5.3	10.6						

Source: National statistics, national central banks, Haver Analytics LP, Deutsche Bank forecasts

Figure 3: Forecasts: Euroland GDP growth by components and central bank rates

Euroland, % qoq	Q1 16	Q2 16	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17F	Q4 17F	2016	2017F	2018F
GDP	0.5	0.3	0.4	0.6	0.6	0.7	0.6	0.5	*1.8*	*2.2*	*2.0*
Private Consumption	0.7	0.3	0.4	0.5	0.4	0.5	0.5	0.5	*2.0*	*1.8*	*1.9*
Gov. Consumption	0.8	0.3	0.2	0.4	0.2	0.5	0.2	0.2	*1.7*	*1.2*	*0.9*
Investment	0.3	2.7	0.1	1.5	-0.2	2.0	1.0	0.9	*4.5*	*2.7*	*3.1*
Stocks (contribution)	-0.1	-0.1	0.1	0.1	-0.1	0.0	0.0	0.0	*-0.1*	*0.2*	*0.0*
Exports	0.5	1.1	0.6	1.5	1.3	0.9	1.1	1.0	*3.3*	*4.8*	*4.2*
Imports	0.5	1.9	0.5	1.9	0.4	1.5	1.2	1.1	*4.7*	*4.7*	*4.3*
Net Trade (contribution)	0.0	-0.3	0.1	-0.1	0.4	-0.2	0.0	0.0	*-0.5*	*0.2*	*0.1*
HICP inflation, % yoy	0.0	-0.1	0.3	0.7	1.8	1.5	1.4	1.4	*0.2*	*1.5*	*1.4*
Core inflation, % yoy	1.0	0.8	0.8	0.8	0.8	1.1	1.2	1.2	*0.9*	*1.1*	*1.4*
EMU4 GDP, % qoq											
Germany	0.6	0.5	0.3	0.4	0.7	0.6	0.6	0.5	*1.9*	*1.9*	*1.8*
France	0.6	-0.1	0.1	0.6	0.5	0.6	0.5	0.4	*1.1*	*1.7*	*1.7*
Italy	0.3	0.1	0.3	0.4	0.5	0.3	0.4	0.3	*0.9*	*1.5*	*1.2*
Spain	0.7	0.8	0.7	0.7	0.8	0.9	0.8	0.6	*3.3*	*3.0*	*2.5*
Central Bank Rates (eop)											
ECB refi rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00			
BoE bank rate	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.50			
US Fed funds target rate	0.375	0.375	0.375	0.625	0.875	1.125	1.125	1.375			
PBOC 1Y deposit rate	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50			
BoJ O/N call rate[f]	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10			

Source: National statistics, national central banks, Haver Analytics LP, Deutsche Bank forecasts. (a) Euro Area and the Big 4 forecasts are frozen as of 13/10/2017. All smaller euro area country forecasts are as of 25/09/17. Bold figures signal upward revisions. Bold, underlined figures signal downward revisions. (b) Annual German GDP is not adjusted for working days. (c) HICP figures for euro-area countries/UK (d) Current account figures for euro area countries include intra regional transactions. (e) The regional aggregates have been calculated based on the IMF weights released in October 2017. (f) Since Feb-2016, Bank of Japan introduced a negative interest rate (interest rate on bank reserves) and the overnight call rate is no longer the policy rate for Japan. (g) Denmark fiscal balance % GDP forecasts are EC forecasts. (h) Financial year forecast for fiscal balance.

European integration and the role of the ESM

Why the focus on ESM reform?

Crisis resolution. Europe is following two complementary and interconnected paths to resolve its economic crisis. The necessary but not sufficient path to resolution is economic rebalancing and structural reform – correcting imbalances and making economies flexible enough to recalibrate so that imbalances do not persist and grow as they did before.

This path has not been hugely effective, it entailed high political costs with the rise of populism and still leaves the financial stability of member states -- and the euro area at large -- susceptible to large shocks.

The sufficient path to resolution comes from integration or burden-sharing between euro area member states. Willingness to create common funds is conditional on commitments to delivering on rebalancing and reform. Only partial progress has been made along the integration path, for example, the limited liability ESM sovereign backstop and a partial banking union (common supervision and a common resolution fund but still no common deposit insurance).

The Macron Pivot. Europe has been afforded an opportunity to accelerate its integration efforts. Emmanuel Macron beat Marine Le Pen on an openly reformist and pro-EU/pro-euro area ticket. Macron is looking towards Germany to reinvigorate a partnership that has always been important to closer union. Based on the rhetoric in recent months, Angela Merkel appears to recognize the importance of this opportunity to improve the stability and durability of the EU and euro area.

Discussing integration. Markets should expect a significant step up in the intensity of euro area reform discussions in the coming weeks:

- 6 November: the Eurogroup will discuss ideas, although no agreement is expected at this point
- 6 December: the European Commission will publish proposals
- 15 December: the European Council (heads of state and government) will discuss integration.

The European Council would like an agreement by mid-2018 after which there would be a period for approval and implementation. Given the lengthy coalition negotiations in Germany to form a new government but also with a view to upcoming elections in Italy early next year this might be rather ambitious.

Repurposing the ESM. One proposal that is mentioned in the debates in France and Germany is a repurposing of the ESM as a "European Monetary Fund". Using a Q&A format, we consider what reforms might mean for the euro area's bailout fund.

What are the current responsibilities of the ESM?

- **Responsibilities as per ESM treaty.** The ESM was created in 2012 in order to provide financial assistance to euro area member states that are currently in or are facing "severe financing problems".[1] The ESM treaty was signed as an intergovernmental treaty (it is not part of EU law) between euro area members, taking over the responsibilities of the temporary European Financial Stability Facility (EFSF). Unlike the European Central Bank or the European Investment Bank (EIB), the ESM is not an EU but an intergovernmental institution.[2]

- **ESM tools.** In order to fulfill its mandate the ESM currently has six tools at its disposal:

1. Loans to countries in macroeconomic adjustment programmes (currently used by: Ireland, Portugal, Greece, Cyprus)
2. Purchasing bonds of an ESM member state in the primary…
3. …or secondary market (both unused)
4. Precautionary financial assistance in the form of a credit line (unused)
5. Indirect bank recapitalization – financing recapitalization of financial institutions through loans to governments, including non-programme countries (currently used by Spain)
6. Direct bank recapitalization as an instrument of last resort (unused)

- **Capital structure.** The ESM's subscribed capital is EUR704.8bn, its paid-in capital EUR80.4bn. The ESM's maximum lending capacity is EUR500bn, while disbursed assistance amounts to EUR87.8bn. Each ESM member (i.e. EA member) contributes to the ESM capital according to the country's share of the EA total population and its share of euro area GDP. The capital key takes into account the accession of new EA members. The ESM can raise funds by issuing financial instruments or by engaging in money market transactions.

- **Governance framework.** The Board of Governors is the highest decision-making body of the ESM. It comprises government representatives (Finance Ministers) of each of the 19 EA members. Representatives of the Commission and the ECB can participate in Board meetings as observers. The Board of Governors is chaired by the President of the Eurogroup. Important decisions such as stability support to an ESM member, choice of instruments and adapting the ESM's lending capacity require unanimity.[3]

1 ESM treaty (2012).
2 The ESM was created in 2012 in response to the Eurozone sovereign debt crisis. To avoid a lengthy ratification process that would have been required by including the ESM in EU treaties, it was signed as an intergovernmental treaty between the EMU members. An amendment to EU treaties allowed the establishment of the ESM, while full integration of the ESM into EU law after 2017 is foreseen.
3 The ESM treaty also includes an "emergency voting procedure" for granting financial assistance if decided by a "qualified majority" of 85% of the voting rights (equal to members' share in ESM paid-in

Figure 4: ESM key facts

Total ESM/EFSF loans disbursed	EUR273.3bn
ESM remaining lending capacity	EUR376bn
Percentage of ESM lending capacity available	75
ESM paid-in capital	EUR80.4bn
ESM/EFSF loans : IMF loans, 2011-2015	2.5 : 1
No. of countries successfully exiting programmes	4
Avg interest rate charged on ESM loans	1.06%

Source: Deutsche Bank, ESM

What are the proposed reforms to the ESM?

Key European players, including the European Commission, the German and French government all seem to pay lip service to the idea of **transforming the ESM into a broader European Monetary Fund** in order to more efficiently address future crises in the monetary union. However, in terms of future functions and governance of such an enhanced institution, views in Europe vary substantially.

- **The European Commission** came out with a reflection paper on the future of EMU this May, summarizing and developing ideas on the future role of the ESM:[4]

1. Transforming the ESM into a "European Monetary Fund" that would reduce the dependence of the euro area on international institutions such as the IMF in order to secure financial stability
2. A credit line from the ESM to the Single Resolution Fund (SRF) as a last resort backstop to banking union
3. Integration of the ESM treaty into EU law, also with view to "future instruments and financing mechanisms" that might require treaty changes anyway
4. Financing of a macroeconomic stabilization function (the ESM is here mentioned as one possible source of financing, alternatives would e.g. be a new line in the EU budget or creation of new instruments).

According to the Commission's paper, the future ESM/EMF would be anchored under a euro area Treasury (which is envisaged to be headed by an EU Finance Minister, who would also chair the Eurogroup/ECOFIN). Commission President Juncker emphasized in his September State of the Union address that the EMF would have to be "firmly anchored in the European Union's rules and competences", a statement that shows the Commission's wariness of any perceived attempts to sideline Brussels in their fiscal competencies and to allow the euro area to further develop its own institutions.

The Commission's outline to certain extent overlaps with recent comments by **ESM Managing Director Klaus Regling**. He spoke out against building "double

capital), effectively giving Germany (27% of ESM capital), France (20% of ESM capital) and Italy (18% of ESM capital) veto power; see ESM (2017): "Explainers".

4 See Focus Europe (9 June 2017): "EMU reflection paper-mere "wish list" or plausible way forward?".

structures" by transferring the Commission's responsibility for fiscal surveillance to the ECB but rather sees the ESM and Brussels cooperating closely on these matters.[5]

- **EU governments** have so far provided little detail on the functions and governance of an enhanced ESM, the only exception being the former German finance minister, **Wolfgang Schäuble**.[6]In a short document referred to as "non-paper" and presented to peers at (Schäuble's last) Eurogroup meeting in October, he outlined his vision for an EMF.

Schäuble sees a European Monetary Fund as an opportunity to impose stricter fiscal supervision and control on national budgets – possibly also by taking away competencies from the Commission. According to his draft a European Monetary Fund:

1. should receive a mandate for crisis prevention (monitor country risks comparable to IMF Article 4 consultations, monitor member states' compliance with Fiscal Compact)
2. could "gradually be given a stronger, neutral role with regard to the monitoring of the Stability and Growth Pact" and later a transfer of responsibility for the oversight of fiscal rules from the European Commission to the ESM
3. should include a debt restructuring mechanism in order to strengthen market discipline and minimize the moral hazard of a bailout fund (automatic extension of sovereign bond maturities under an ESM program, an obligatory "comprehensive" debt restructuring if necessary to warrant debt sustainability, and a single-limb aggregation amendment to collective action clauses to prevent holdouts)
4. could provide a fiscal backstop to the SRF.

The "non-paper" paper rejects to use the ESM and its capacities as a:

1. fiscal backstop for the discussed but controversial European Deposit Insurance Scheme (EDIS)
2. "transfer mechanism for the Eurozone" in form of a new fiscal capacity

Based on his 26 September speech on Europe, French President **Emmanuel Macron's** vision is different to Schäuble's:

- Convergence and stability should be achieved via reforms but also coordination of economic policies and stabilisation tools for countries facing economic shocks.
- The preferred way to achieve it would be a stronger budget with strengthened parliamentary control amid the respect of agreed rules and necessary national reforms.

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5 Interview with the Handelsblatt (13 July 2017).
6 Schäuble was elected speaker of the German Bundestag on October 24 and was provisionally replaced as finance minister by Head of the Chancellery and Minister for Special Tasks Peter Altmaier.

More generally, the vision of French policy makers could be summarised as:[7]

- Additional stabilisation and risk sharing via a common investment budget, unemployment insurance scheme, deposit insurance and a permanent backstop for the single resolution fund (SRF).
- While stronger fiscal discipline would be acceptable, further market discipline would not be.

Note: neither Germany nor France is proposing debt mutualisation.

Figure 5: Thinking about the scale of ESM reform

Scale of ESM reform	Small	Medium	Large
Scope	Reforms achievable without modifying ESM Treaty	Reforms achievable with changes to ESM Treaty	Reforms achievable with changes to ESM and EU Treaties
Example	New lending facility consistent with mandate to support stressed sovereigns	Expanding the mandate of the ESM to conduct preventive crisis monitoring	Moving oversight responsibility for fiscal rules from Commission to ESM
Legal/Political requirement	ESM Board approval	National government approval	National approval, in some cases via referenda
Would this facilitate fiscal transfers or debt mutualisation?	No	No	No

Source: Deutsche Bank

What does a European Monetary Fund do that the ESM does not?

With both France and Germany talking about a 'European Monetary Fund', it follows that the ESM is not already the European equivalent of the IMF.

The primary purpose of the IMF is "to ensure the stability of the international monetary system—the system of exchange rates and international payments that enables countries (and their citizens) to transact with each other. The Fund's mandate was updated in 2012 to include all macroeconomic and financial sector issues that bear on global stability".

The purpose of the ESM is "to mobilise funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States".

The ESM responds to requests for funding when sovereigns are suffering from or threatening with a financing problem. The IMF's responsibilities are more encompassing, including ex ante monitoring of risks and the provision of expert

7 "Germany should accept more risk sharing – and France more market discipline", An appeal by French and German economists, Petersen Institute for International Economics, 27 Sept 2017.

advice, a role which some would like the ESM to play in addition to or in place of the European Commission.

However, the analogy of a reformed ESM being a 'European Monetary Fund' is not perfect. Arguably, the French vision of what is required to strengthening the euro area stability goes beyond just a local version of the IMF. At the same time, Schäuble's vision of tougher investor conditionality — to increase market discipline and protect the EU treaty "no bailout clause" — clashes with the French vision. In any case, a sovereign debt restructuring mechanism is something the IMF has itself struggled get agreement on internationally.

The **academic debate** on the repurposing of the ESM as a European Monetary Fund has also gained momentum.

- The Brussels-based economic think tank Bruegel came out with recommendations to design a future EMU as a "fiscal counterpart of the ECB".[8]They support the idea of:

1. a European Sovereign Debt Restructuring Mechanism to strengthen market discipline
2. ESM/EMF as a fiscal backstop to a "Single Resolution and Deposit Insurance Fund" — their vision of combining the two bodies of the Single Resolution Fund (established, to be build up until 2023) and the European Deposit Insurance Scheme (under discussion)
3. replacing the unanimity rule for ESM vote with supermajority.

- The European Parliament sought external opinions on the matter of creating a European Monetary Fund and commissioned three academic papers that were released over recent months.[9]

1. Charles Wyplosz from the Graduate Institute Geneva sees the ESM already in its current form as being in "fundamental contradiction with the no-bailout rule", an extension into a European Monetary Fund causing conflicts of interests among member states and doubling of existing EU/Eurosystem structures. He suggest to use existing IMF structures rather than trying to replace them.
2. For Daniel Gros from the Center for European Policy Studies the ESM "already constitutes to a large extent a 'European Monetary Fund'." He sees no benefit in transferring fiscal monitoring/economic policy coordination functions from the Commission/European Council to the ESM but sees potential for the Commission and ESM to share the responsibility to prepare EA country reports under the Macroeconomic Imbalances Procedure and prepare 'corrective action plans'.
3. Jonathan A. Rodden from Stanford University raises general doubts whether proposals for "stronger top-down surveillance and correction mechanisms" for the Eurozone might prove fruitful as the EMU members are unlikely to give up (fiscal) sovereignty.

8 Sapir, André (2017): "The time is right for a European Monetary Fund ", Policy Brief Issue 4 October 2017, Bruegel.
9 European Parliament (2017): European Stability Mechanism (ESM): "Main features, Instruments and Accountability".

What is the legal process of reforming the ESM?

The ESM was signed in 2012 as an intergovernmental treaty in order to swiftly replace the expiring temporary EFSF and EFSM programmes, and avoid a lengthy ratification process including national referenda, with a permanent crisis resolution framework. EU law was only changed through an amendment to the TFEU (Article 136) that allowed for the establishment of a euro area stability mechanism. The expectation is the ESM treaty will be integrated into EU law after 2017.[10] Transforming the ESM further and providing it with a broader mandate can become a legally and politically complex — and therefore protracted — process, depending on whether the proposed ESM reforms require ESM treaty alone or also EU treaty changes.

- **Reforms not requiring ESM treaty change.** Under the ESM treaty, no amendments are required to expand the capital stock or adapt the maximum lending volume of the fund; this can be decided by the Board of Governors (i.e. EA governments according to their applicable national procedures) through a unanimous vote. The choice of instruments and conditionality in order to provide stability support to ESM members, financial institutions and "other third parties", is in principle also up to the Board of Governors' and is thus at EA members' discretion. [11]
- **Reforms requiring ESM treaty change.** In practice, however, adding new functions, such as a **fiscal backstop to the Single Resolution Fund**, would call for ESM treaty changes. The ESM treaty programmes require country-specific conditions specified in a Memorandum of Understanding (MoU) as well as Financial Assistance Facility agreements with the affected member state. These conditions would not be applicable in the SRF context. In addition, the SRF might lead the resolution of banks with subsidiaries outside the euro area, while the ESM's mandate foresees lending only within the currency bloc.[12] Also for granting the ESM **fiscal monitoring powers** over euro area members (together with the Commission), ESM treaty changes would be necessary. The same applies to anchoring **a debt restructuring mechanism** including automatic sovereign debt maturity extensions and CAC amendments in ESM programs. A change of the ESM treaty requires mutual agreement, thus needs to be ratified by all euro area member states.
- **Reforms requiring EU treaty change.** Much more difficult would be moving **oversight responsibility for the European fiscal rules** from the Commission to the ESM. This would require a change of the TFEU (Article 121 and Article 126) which needs to be ratified by all EU countries (and in some countries also requires national referenda). This would most likely be complicated by headwinds against further euro area integration particularly from EU members outside the currency bloc who might feel increasingly sidelined by a "multi-speed" approach to European integration. Naturally, strong resistance would come from Brussels, where the European Commission would see its competencies strongly diminished.

10 European Parliament (2017): "Integration of the ESM into EU law".
11 ESM treaty (2012).
12 European Commission (2015): "Bridge Financing Options for the Single Resolution Fund".

Potential institutional and political hurdles to ESM treaty reform. Previous rulings by the European Court of Justice and the German Constitutional Court on the ratification of the 2012 ESM treaty might give some guidance to the legal hurdles to ESM reform, both on the EU and national level.

In 2012, the ECJ found that the ESM treaty is compatible with EU law as *"Article 125 TFEU does not prohibit the granting of financial assistance by one or more Member States to a Member State which remains responsible for its commitments to its creditors provided that the conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy"*. [13]

In 2014, the German Constitutional Court confirmed in a second ruling (following the rejection of a constitutional complaint in 2012) that *"the budgetary autonomy of the German Bundestag is sufficiently safeguarded. However, arrangements under budgetary law must be made to ensure that possible capital calls pursuant to the ESM treaty can be met fully and in time within the agreed-upon upper limits, so that a suspension of Germany´s voting rights in the ESM bodies is reliably excluded"*.[14]

All future reform proposals need to comply with the **"no bailout" clause** of Article 125. This links financial assistance from the ESM to strict conditionality and ensures that "permanent transfers" are avoided.[15]. This would certainly also apply to any new **macroeconomic stabilization** function, independently from whether it is anchored in the ESM or financed through other sources.

From a German perspective, the budgetary autonomy of the Bundestag remains key for assessing any changes to the ESM and EU treaties. **Replacing the unanimity rule for ESM votes with a supermajority** as proposed in the Bruegel policy paper would almost certainly be rejected by the German constitutional judges as it could lead to an overruling of the German Bundestag regarding the ESM's lending capacity and Germany's obligations through the ESM's capital key. According to Bruegel, granting German veto power could solve this issue.

Apart from the above mentioned legal and constitutional considerations, it is highly likely that the **German Bundestag** will be involved in all changes of the ESM – for political reasons. It can be expected that any changes to the ESM, in particular those that include an expansion of funding and ESM mandate, will be subject to complaints to the **German Constitutional Court**. The broader the parliamentary support for a modification of the ESM mandate – possibly including parts of the opposition in the Bundestag – the stronger will be the position of the government in prospective lawsuits.

While ex-post complaints against an EU agreement on an even modest reform of the ESM might delay its implementation, the short-term hurdles are likely to be expected from the formation of a new government in Germany following the September 24 elections – both in terms of content as well as timeline. European policy remains one of the more contentious issues between the four parties to form the so-called **Jamaica coalition** (CDU, CSU, FDP, Greens).

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13 ECJ judgment on ESM (27 November 2012).
14 German Federal Constitutional Court (18 March 2014).
15 European Commission (2017): "Reflection Paper on the deepening of the Economic and Monetary Union"

The **FDP**, in particular, is focusing more on a rules-based approach to euro area integration and is reluctant to engage in far-reaching expansion of crisis tools. In its election platform it calls, inter alia, for a phasing out of the ESM, the introduction of an insolvency (debt restructuring) mechanism for sovereigns and a treaty-based possibility for an euro area member to exit the euro without losing EU membership.

While positions in election platforms do not automatically translate into coalition agreements and real politics, the FDP is likely to insist that modifying the ESM and providing more funding is strictly conditional and does not undermine sovereign and bank efforts to address structural shortcomings. This cautious approach is backed by German public opinion. Given that the other smaller coalition partner, the **Greens**, support a much more integrationist approach in terms of crisis tools and fiscal union it can be expected that the coalition agreement will provide guidance for the new German coalition government for respective talks at the EU level.

While the EU Commission pushes for swift decisions and the French government would like to see support from Germany in this regard, the timeline might be slipping. Currently it looks rather unlikely that Chancellor Merkel will be re-elected as chancellor before Christmas. This implies that Germany might find it difficult to agree on certain topics at the EU Summit on Dec 14/15.

Is there scope for compromise on an ESM reform agreement?

European integration tends to be characterized by compromise and conditionality. The extent to which the ESM is reformed will be a function of the extent to which:

- Europe wants to and can take advantage of the time-limited opportunity presented by the Merkel-Macron partnership to strengthen in the euro area. Macron needs to see dividends from his European integration policy push ahead of the next elections in 2022.
- the ESM is the right framework to achieve a more integrated euro area economy. There are alternatives, as Schäuble argues, like a more integrated EU Budget.
- Germany accepts that the ESM's role ought to be interpreted more broadly as addressing the negative feedback loop between banks and sovereigns and not just stressed sovereigns per se.
- Europe decides to re-engage market discipline in the control of fiscal policy by introducing stricter private investor conditionality in the event of ESM interventions.

Schäuble's 'non-paper' puts Germany at the **minimal** end of ESM reform as far as new tools are concerned. Schäuble's vision does not rule out institutional reforms but sees them being achieved through alternative channels like the EU Budget or revised fiscal rules. Schäuble puts the emphasis on new preventive monitoring responsibilities at the ESM as well as introducing tougher conditions governing intervention (e.g., automatic maturity extension for investors).

There are arguments in favour of a more **maximal** approach to ESM reform. For example, the ESM exists. It is a proven entity. It has a market footprint in terms of issuance and is scalable. It would be relatively easy to adjust the ESM treaty to expand the institution's responsibilities. A more maximal approach also avoids forcing integration through alternative channels, a process which could entail the duplication of costs entailed in creating new institutions.

A **compromise** cannot be ruled out. There is normally some give-and-take in European negotiations. Other countries might accept tougher conditionality and ESM preventive monitoring in exchange for additional stabilisation tools. Schäuble's paper does not comprehensively rule out funding for structural reforms, for example, and both the Commission proposals and recent speeches by ESM Managing Director Klaus Regling support some kind of modest counter-cyclical mechanism.

Figure 6: ESM reform discussion opens up the possibilities to expand the institution's remit

	Maximal ESM reform	Minimal ESM reform
Pros	ESM exists and has proven ability; has market presence and scalable issuance	ESM responsibility can remain focused on original sovereign-specific mandate
Cons	Stretches ESM governmance with additional responsibilities	Need new intergovernmental agreements or Treaty changes to deliver integration goals

Source: Deutsche Bank

What is the connection between ESM reform and banking union?

One potentially significant dimension to ESM reform is its role in facilitating the completion of banking union. This could be part of what unlocks a compromise deal on ESM reform.

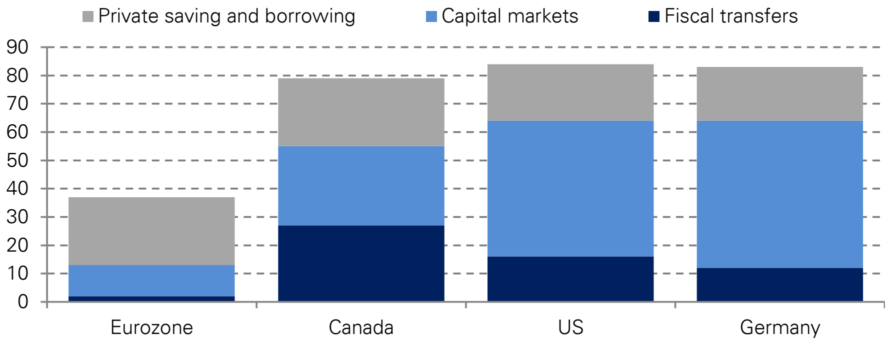
Cross-border banking and capital flows would be consistent with both the French and German visions of economic integration. These flows would on the one hand help finance growth – satisfying French demands – and on the other improve euro area resilience to shocks – satisfying German demands. This points to the need for the euro area to complete banking union (BU) and the capital markets union (CMU).

EU leaders say there is a **sequence** to integration and completing the banking union comes first. Completing the banking union would be growth-positive, but rushing the correction of legacy risks could entail adjustment costs. If completing banking union is necessarily slow, progress on general integration would also be slow.

That could clash with the political reality that Merkel and Macron have a time-limited opportunity to act to strengthen the euro area. This means pressure for compromises within ESM reform discussions — the ESM is easier to reform than the EU treaty — and some convergence toward the more expansive visions of the ESM is likely. The question is, at what cost?

Figure 7: Precisely because it rules out fiscal transfers, the euro area needs to develop the banking and capital markets unions to be able to absorb shocks like other comparable integrated regions

Degree (in %) to which regional consumption is insulated from regional GDP fluctuations by fiscal transfers, capital markets and private saving/borrowing



Source: Deutsche Bank,"Towards a fiscal union for the euro area", IMF staff discussion note, September 2013. Note, data for Eurozone is pre-2008 before inter-bank lending froze and cross-border banking flows reversed

There are two key missing elements from the banking union, both of which could potentially be backstopped by the ESM:

Single Resolution Fund. When fully funded, this is expected to have EUR55bn at its disposal. The resources are accruing gradually from member states until 2023, but a new crisis in the meantime would mean the facility has less resources than intended. Member states agreed in principle in 2013 to provide a fiscal backstop to the SRF, it has not been enacted yet because of still considerable legacy banking issues, namely high NPL rates and high sovereign exposures.

European Deposit Insurance Scheme. National deposit guarantee schemes already guarantee eligible deposits up to EUR100,000. The EDIS would backstop the national schemes, increasing their credibility in the face of large banking shocks and further reduce the risk of bank runs. The European Commission describes the combination of EDIS with a reduction of banks' sovereign exposure home bias as amplifying resilience to large local shocks. The Commission's proposal is similar to the SRF – to gradually transfer resources from national guarantee schemes to the EDIS and create a backstop to ensure its financing.

Schäuble's 'non-paper' sees a difference between how the ESM could support these two missing pieces of banking union:

SRF. The Schäuble paper says that only if the current risk reduction proposals "step up" could the ESM play a backstop role for the SRF. [16]

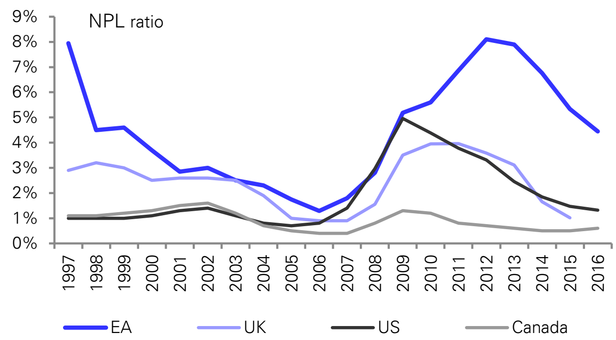
EDIS. The Schäuble paper says that more ambitious plans for ESM reform including backstopping the EDIS would "put too much strain on the ESM and go against its core purpose of bailing out sovereigns in severe trouble".

This is an unofficial document of a former finance minister and is not worded with legal precision. As worded, there may be scope for a conditional deal to unlock

16 Euro area gross non-performing debt instruments were 3% of total gross debt instruments in 2007, rose to 5% in 2013 and have declined to 4% in 2017, according to European Commission data: http://ec.europa.eu/finance/docs/law/171011-communication-banking-union_en.pdf

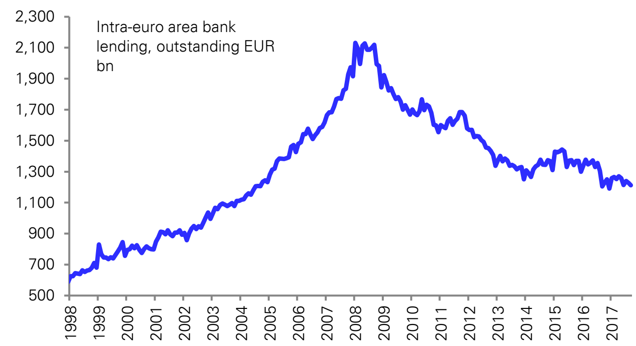
ESM funding for the SRF if current risk reduction proposals are stepped up. The prospects for an EDIS backstop seem more limited.

Figure 8: Euro area NPL rates are declining but remain comparatively high



Source: Deutsche Bank, World Bank

Figure 9: Cross-border bank lending inside the euro area has not recovered – completing Banking Union could spur some normalisation



Source: Deutsche Bank, ECB

SRF and NPL reduction. The level of risk in backstopping the EUR55bn SRF may be perceived as lower. The stated intention is a fiscally-neutral facility – if resources need to be drawn before the fund is fully financed by national contributions and the ESM is required to finance the shortfall, the plan would be for the ESM loan to be repaid by bank levies, not tax revenues or alternative forms of sovereign financing. Perhaps it would not take much in terms of clarifying, for example, the framework for NPL reduction, to unlock an agreement on an ESM backstop for the SRF.

According to DB banks analysts, the Single Supervisory Mechanism (SSM-ECB) NPL programme is well in train. Earlier this year, the SSM published final guidance to banks. In short, banks are required to come up with a clear strategy for reducing NPLs, a strategy which includes setting ambitious but realistic targets and putting in place relevant governance and operational structures. All this keeps an elevated focus on banks with above-average NPL ratios, for example, in Italy, Portugal, etc.[17]

On 11 July 2017, the EU Council proposed a plan to tackle the European NPL issue. We believe that the recent EU Council proposals for a European comprehensive approach to deal with NPLs could help in particular smaller banks to accelerate the implementation of their NPL strategies. This should ultimately be positive for the rest of the banking system as well, further reducing pending risks.

ESM treaty change and banking union. Schäuble is right to question the legitimacy of an ESM backstop for the SRF or EDIS given the ESM mandate. According to the ESM treaty, its purpose is to *"mobilise funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are*

17 "Road to recovery: rates, regulation and return", European Banks Strategy, Deutsche Bank, 31 August 2017.

threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States".

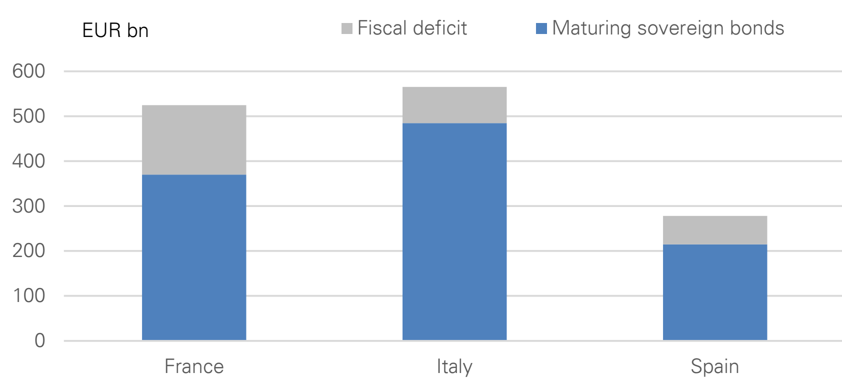
The ESM can only lend to an ESM member, that is, a sovereign state, not an entity like the SRF or EDIS. As worded, the ESM mandate is sovereign specific. As such, it is not targeted at relieving the sovereign-banking nexus. One can argue the banking union (single supervisor, single resolution fund, the Bank Recovery and Resolution Directive, EDIS) targets that negative feedback loop. However, completing the banking union requires a fiscal backstop that can only come from sovereigns. The credibility of the new regime's ability to separate sovereign and banking risks would benefit if the ESM treaty were amended to allow it to backstop entities like the SRF and EDIS.

How much larger might the ESM need to be?

The market has a strong interest in knowing where on the Franco-German spectrum a reformed ESM will lie. The ESM has a footprint in markets and with investors. ESM bonds are eligible as ECB collateral and for the QE programme. In short, the ESM is scalable. However, the mooted economic convergence mechanisms, even if implemented, need not increase the ESM lending capacity much, as we argue below.

The answer to the question, how large might the ESM lending capacity need to be, has two parts. First, is the ESM large enough to satisfy its current remit? Second, how much larger might the ESM need to be if it were to be given responsibility for some of the convergence and crisis tools that are mooted?

Figure 10: Size of standard bailout programmes* would decline significantly if there was automatic maturity extension



*Source: Deutsche Bank, *standard sovereign bailout programmes assuming 2.5 years of funding for deficits and maturing sovereign bonds*

We do not want to spend too much time on the first part of the answer. First, because the governance structure of the ESM already allows for the lending capacity to be reviewed if necessary. Second, if the German proposal for automatic extension of maturities were to be adopted or enforced, it would significantly reduce the size of a standard full bailout programme.

There could be significant ramifications for sovereign markets if automatic maturity extension were to be adopted or enforced. Hypothetically, it could substantially reduce the size of a standard bailout. For the sake of argument, if

Italy were to request an ESM bailout programme today and if this was structured like the programmes agreed during the debt crisis — 2.5 years of funding for deficits and maturing debt – it would equate to roughly EUR90bn with an automatic extension of debt and over EUR500bn without an automatic extension.

In terms of estimating the potential size of new ESM tools, we focus here on three mooted tools: a counter-cyclical buffer, funding for structural reforms and a public investment spending protection scheme.

- **Counter-cyclical buffer.** One way to think about how large counter-cyclical buffer would need to be is to look at the cyclical component of the euro area budget, that is, the part that captures the automatic stabilisers. For every 1pp increase in the output gap, the cyclical deficit would be 0.5% of GDP. Assuming the entire euro area was hit by an economic shock worth 1% of GDP this would require an ESM counter-cyclical tool of 0.5% of GDP or about EUR50bn (the median recession among euro area member states is 0.8% of GDP).[18] One could argue that not all countries would draw on the tool – potential stigma costs – and that the size could be smaller. Moreover, if the intention is more specifically a common unemployment insurance fund, the size could be smaller since this covers just part of the cyclical deficit. On the other hand, one could argue that covering a standard recession might not be sufficient insurance and that the tool should be larger for credibility purposes. Net-net, EUR50bn might be a good start if the ESM board has the authority to increase the size of the tool if necessary.

- **Funding for structural reforms.** Within the Stability and Growth Pact rules a country can deviate from its required fiscal path (defined by its medium-term objective or MTO) by up to 0.5% of GDP if there are sufficient structural economic reforms. Were the ESM to introduce a tool whereby this reform-based deviation was financed centrally and all member states were to avail of this facility at the same time, it would require EUR50bn of lending capacity. The way the Stability and Growth Pact is worded implies that the 0.5% of GDP reform leeway can be granted for one year or spread over two years. It does not allow for more comprehensive multi-year reform programmes. To be consistent with the SGP – and we would expect a tool to be designed this way – an ESM facility would not need to be larger than EUR50bn.

- **Public investment spending protection.** The EU roadmap refers to an "investment protection" fund. The EIB and EFSI already exist to finance and stimulate investment spending and there is no need to reinvent the wheel. The approach could be to ensure that governments maintain public investment spending during downturns and episodes of consolidation. At the euro area aggregate level, median public GFCF in the ten years prior to 2007 was 3.2% of GDP. The median in the five years to 2016 was 2.7% of GDP, a fall of 0.5% of GDP.[19] This correction was during an unprecedented downturn, so might be a maximum. However, capital spending generally needs a multi-year commitment. Hence 0.5%

18 This assumes that trend GDP growth remains unchanged. The larger the economic shock, the less safe this assumption.

19 The median decline for the euro area member states that received a full sovereign bailout (Greece, Ireland, Portugal, Cyprus) was 1.8% of GDP. If a tool of this size was scaled up to euro area level, the ESM would need close to EUR200bn per year.

of GDP or EUR50bn per year could be a reasonable starting point — EUR100bn to cover two years if EU wants to better protect multi-year public investment projects — as long as the ESM board has the authority to increase the size if necessary.

Cumulatively, the above three tool would imply a **EUR150-200bn** increase in the ESM lending capacity. This is quite likely an overstatement, for several reasons:

- It is unlikely euro area leaders agree to implement all these tools.
- Even if all three were implemented, the tools are not mutually exclusive. For example, financing structural reforms could allow public investment spending to be maintained.
- Credible tools that prevent and/or buffer a crisis should reduce the risk of entering a full-blown sovereign crisis and thereby reduce the probability of major bailout programmes being drawn from the ESM.

A final few points on new financing tools.

- **Eligibility.** The power of such tools is in part a function of their accessibility. They are not intended to be last resort sources of funding. However, to avoid moral hazard, there needs to be a basis for qualification. For example, the tools may only be available to countries that are in full compliance with the Stability and Growth Pact, Macro Imbalance Procedure and country-specific recommendations (CSRs) from the European Commission. This creates a stronger incentive for compliance.
- **Costs.** The ESM treaty makes it clear that all interventions supported come with costs detailed in a Memorandum of Understanding (MoU). The same would have to apply to these tools. This does not have to be austerity-based conditions. It could relate to the introduction of reforms, fiscal or structural.
- **Ex ante vs ex post financing.** It would be easier to structure tools that are ex ante in nature (that is, funding expenditure that has yet to take place). Automatic stabilisers operate in real time and economies don't always know in real time whether they are in recession. Rather than agreeing to finance a portion of a deficit that has already occurred, it would be easier for the ESM to finance future public plans, for example, within a funding for structural reforms tool or public investment spending protection tool.
- **Alternative approaches.** As Schäuble's paper argues, there are other ways the economic integration objective could be delivered outside the ESM, for example, through the EU Budget reforms (including an EA Budget), simplification/revision of the fiscal rules, etc; bear in mind, for example, that the fiscal rules have been redefined in cyclically-adjusted terms so already have a "counter-cyclical" element. Failure to see new tools materialize in the ESM does not necessarily mean such tools won't materialize elsewhere within the EU's institutional framework.

Conclusion: A reformed ESM but limited in scope and scale

In our view, the need for Europe to maximize the time-limited opportunity for integration created by Merkel and Macron's leadership of the euro area's core economies is likely to translate into pressure for compromises within the ESM reform discussions. After all, the ESM treaty is easier to reform than the EU treaty. We expect some limited convergence toward the more expansive visions of a reformed ESM. At best this may entail a backstop for the SRF and a small new stabilization tool.

There will likely be conditions attached and it is the net position that markets will respond to. With deposit insurance not on the agenda yet, an agreement on how to reduce banks' high holdings of sovereign debt is probably not imminent. The long shadows cast by Deauville over sovereign markets will likely see opposition to Schäuble's demands for stricter investor conditionality if these are the conditions for an integration agreement.[20] The ECB's ability to exit QE could be compromised by such conditionality.

Differences of opinion between key member states on what is required will constrain the economic integration steps to something modest in scale and scope. As such, the more significant political signals of closer European integration may be more likely to come through common migration and security/ defence policies rather than economic policy, at least in the near term.

20 Chancellor Merkel and then French President Sarkozy met in Deauville on 19 October 2010 and agreed that in future bailouts private investors would have to make a contribution. This was seen as contributing the sovereign market pressures in 2010 and 2011 and in the end a substantially watered down version of this demand made it into the ESM treaty.

Central Banks & Financial Forecasts

Euro Area

If the intention was a non-event, the ECB got what it wanted on 26 October – exit with minimal disruption to financial conditions. It will likely be mid-2018 before the ECB actively discusses changing the policy stance again. In the meantime watch growth and inflation. The former is strong and consensus expectations continue to rise. The latter is less convinced, but we are increasingly confident the corner has been turned.

UK

The BOE needs clarity on a Brexit transitional deal to take a second step on monetary exit. A second hike is a risk but we are more pessimistic on growth and see rates staying unchanged in 2018.

Switzerland

Despite a reversal of safe haven flows and CHF depreciation as the euro area recovers, we do not expect the SNB to change its exceptionally loose policy stance before H2 2018.

Sweden

The Riksbank says not to expect a policy rate hike until mid-18 and the market is pricing it in H2-18. The focus at the moment is the tolerance for FX appreciation.

Norway

No changes are expected for a while with Norges Bank's formal projection implying tightening only in mid-2019; the risk is it happens sooner.

Poland

The NBP retains its watchful approach with a bias for a neutral stance. We expect the Bank to keep its rates on hold well into 2018.

Hungary

The NBH retains its ultra-dovish stance. While official policy rate looks set to remain unchanged, further unorthodox easing is still likely.

Czech Republic

The CNB maintains its tightening bias and looks set to raise policy rates gradually to avoid undue appreciation pressure on CZK.

Figure 11: Central Banks & Financial forecasts

Euro Area	Latest	Dec-17	Mar-18	Jun-18
Refi rate	0.00	0.00	0.00	0.00
Deposit rate	-0.40	-0.40	-0.40	-0.40
3m Euribor	-0.33	-0.30	-0.30	-0.30
10Y govt bond	0.36	0.60	0.65	0.70
EUR/USD	1.16	1.17	1.18	1.19
UK				
Bank rate	0.25	0.50	0.50	0.50
3m Libor	0.30	0.50	0.55	0.55
10Y govt bond	1.25	1.45	1.65	1.75
GBP/USD	1.32	1.29	1.28	1.28
EUR/GBP	0.89	0.91	0.92	0.93
Switzerland				
3m Libor Tgt	-0.75	-0.75	-0.75	-0.75
EUR/CHF	1.15	1.05	1.06	1.08
Sweden				
Repo rate	-0.50	-0.50	-0.50	-0.50
EUR/SEK	9.78	9.50	9.38	9.25
Norway				
Deposit rate	0.50	0.50	0.50	0.50
EUR/NOK	9.48	9.75	9.69	9.63
Denmark				
Lending rate	0.05	0.05	0.05	0.05
EUR/DKK	7.44	7.46		
Poland				
2w repo rate	1.50	1.50	1.50	1.50
EUR/PLN	4.28	4.23	4.25	4.26
Hungary				
Base rate	0.12	0.03	0.03	0.05
EUR/HUF	311.08	310.00	312.50	315.00
Czech Rep.				
Repo rate	0.25	0.50	0.50	0.75
EUR/CZK	25.7	26.0	25.9	25.9
Memo				
Japan				
Bank res. rate	-0.10	-0.10	-0.10	-0.10
3m Tibor	0.06	0.05	0.05	0.05
10Y govt bond	0.07	0.00	0.00	0.00
USD/JPY	114.09	116.0	117.0	118.0
US				
Fed Funds Tgt	1.125	1.375	1.375	1.625
3m Libor	1.32	1.58	1.58	1.83
10Y govt bond	2.35	2.62	2.69	2.75

Source: Deutsche Bank, Bloomberg Finance LP, National Central Banks. "Latest" data updated as of 08:00 BST, 3 November, 2017.

Appendix 1

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*Other information available upon request

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