

Completing Europe's monetary union

European Monetary Fund would help euro area after Italy poll

by Ousmène Mandeng in London

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The new German government may propose as one of its first European policy initiatives the establishment of a European Monetary Fund, a critical missing piece in the euro area monetary architecture. The coalition treaty between Chancellor Angela Merkel's Christian Democrat/Christian Social Union group and the Social Democratic Party states prominently that the 'existing European Stability Mechanism is to be developed into a European Monetary Fund'.

The idea of an EMF is not new and failed a few times in the past to get off the ground, notably when the European Monetary System was set up in 1978 as the forerunner to economic and monetary union. Yet, in the light of continuous nervousness regarding prospects for the euro area, exacerbated by an unfavourable Italian election outcome, an EMF would signal that the bloc is willing to do what it takes to strengthen confidence.

How to implement it though will be a delicate matter. It is surprising that the Maastricht Treaty made no provisions for regular economic policy consultations and financial support of member countries in payments distress.

The predecessor and model monetary arrangement for the EMS, namely the Bretton Woods system and the International Monetary Fund, rests essentially on the notion of surveillance and financial assistance. The composers of the Maastricht Treaty, conversely, seemingly assumed that crises would simply not happen. Adjustment under fixed exchange rates is difficult, and crises do happen.

The idea of an EMF was formulated already in the Werner Report of 1970 on the future of EMU in the European Community. The report clearly identified the need for an EMF for 'monetary support at short term and for financial aid at medium term'. In 1972 at the Paris summit of the EC the decision was taken to create a European Monetary Co-operation Fund. In 1973, the EMCF was established but failed to have a meaningful impact and remained dormant.

In 1978, at the Bremen European Council meeting of the now European Economic Community, a new Franco-German proposal for an EMF to replace the EMCF was formed. But again the project met resistance, in particular from the Deutsche Bundesbank, and was largely abandoned in the light of pressures on the franc in 1981 in the European Exchange Rate Mechanism. In 1989, the Delors committee report discussed but failed to agree on a possible European Reserve Fund. In 2010, the European Financial Stability Fund was formed as a temporary financing facility to help combat the euro area crisis, and in 2012 the ESM followed to replace the EFSF as a permanent institution.

Failure to agree on an EMF in the past was mostly due to resistance by national central banks to equip the new institution with their precious gold and foreign exchange reserves. This is no longer required. The ESM has its own resources (though they may not be sufficient). The critical question is what an EMF will be allowed to do and what mandate it will have to direct euro area countries' actions.

The ESM lacks a surveillance mandate and governance structure that would make it an EMF. An EMF would have to be at least as independent as the European Central Bank and be able to take decisions effectively with finality, including being able to enforce certain economic policy conduct, negotiate adjustment programmes and extend financial assistance. The EMF would have to assume the provisions under the 2012 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and the roles of the European Commission, the ECB and the European Council, including for the excessive deficit procedure and possibly covering actions on sanctions now reserved to the European Court of Justice. The decision-making process needs to ensure that an EMF can credibly pursue a policy that is in the interest of the euro area and not that of individual countries or country groups.

An EMF may still again fail. Agreement on governance and on the level of intrusiveness will be challenging. Notwithstanding, an EMF represents a critical building block to complement and strengthen the euro area. It should have been there in the first place.

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