ON THE SELLING OF SOVEREIGNS HELD BY THE ESCB TO THE ESM

A revised proposal

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Abstract

This paper presents an in-depth review of the proposal by Micossi (2020) and Avgouleas and Micossi (2021) to transfer a substantial share of the sovereigns acquired by the European System of Central Banks (ESCB), both during and before the pandemic, to the European Stability Mechanism (ESM). This is necessary to avoid the potentially disruptive impact of releasing these sovereigns onto financial markets once the monetary policy justifications for the ESCB to hold these sovereigns has been exhausted. Consequently, the ECB would be freed of the risk of fiscal dominance and the financial stability of the euro area would be strengthened. This note argues that the ESM is legally entitled to do this under the Treaty on the Functioning of the European Union (TFEU) and the ESM Treaty (TESM) as an expansion of its basic mission to preserve the financial stability of the eurozone, regardless of any separate monetary policy justification. The main operating instrument for this kind of financial assistance would be the purchase of sovereigns by the ESM from the ESBC under the secondary market support facility of Article 18 TESM. With appropriate modifications of Article 18 – which would not require ratification by the Member States – the conditionality applied by the ESM would mimic that already designed for the precautionary assistance facility of Article 14 TESM, as described in the new Anne III of the reformed TESM. There would be no obstacles for the ESM to leverage its capital as required to finance its sovereign purchases and this would not endanger its Triple A rating. The availability of the safe assets in large amounts issued by the ESM would help strengthen the overall international role of the euro.

LUISS School of European Political Economy

Stefano Micossi is the director General of Assonime, a business association and think tank in Rome, the Chair of the LUISS-SEP School, and a member of the CEPS Board of Directors.

At the beginning of July my dear colleague Emilios Avgouleas fell seriously ill and has yet to recover. This note reflects many exchanges that we had before his illness made it impossible for him to continue his work with me. While I did not feel it appropriate to add his name to this note's authorship, as I cannot make him responsible for my evolving views and possible fresh mistakes, I feel an enormous debt of gratitude to Emilios for this new note. I wish dearly that he recovers soon and comes back to our endeavour that we started almost a year ago together. I also owe deep thanks to Fabrizia Peirce for her outstanding help in understanding the legal texts of the ESM and for continuously updating me on the current academic and policy debate on sovereign debt management during the pandemic. Important suggestions to improve our proposal were made by Paul De Grauwe, Jean Pisani-Ferry and Gian Luigi Tosato. I remain solely responsible for the views expressed in the paper, which is also being published simultaneously as a LUISS SEP Policy Brief. This Policy Insight is being published simultaneously as a LUISS SEP Policy Brief.

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1. Introduction

Micossi (2020) and Avgouleas and Micossi (2021) have argued that the eurozone will need a common policy for sovereign debt management in the post-pandemic world for two reasons. The first is that the pandemic crisis of 2020-21 and the financial crises hitting the eurozone in 2008-2012 have left it with much higher levels of indebtedness, about 100 % of the area's GDP (it had been about 60 % at the time of the euro's inception). The traditional cure for budgetary austerity can hardly be applied to resolve the problem as it would likely compromise the return to sustained economic growth in many Member States, possibly endangering debt sustainability.

The second reason is that the eurozone suffers from a special externality: the fact that the availability of the common currency for stabilising sovereign and banking markets in any one country hit by an idiosyncratic shock requires the consensus of the ECB Governing Council, which may not always be forthcoming, as we learnt in 2011-12, leading to self-fulfilling financial crises in the Member State concerned, as well as in other Member States due to contagion effects.

The specific question requiring common action is the management of the large sovereign debt holdings accumulated by the European System of Central Banks (ESCB; in fact, sovereigns are held country by country by their national central banks, NCBs) following purchase programmes enacted to counter price deflation, as interest rates fell close to their lower bound. The common action problem arises because at some stage in the future the monetary policy justifications for those sovereign holdings will disappear, as inflation returns to its 2 % target and, therefore, the ECB will no longer be allowed to hold them under the established jurisprudence of the European Court of Justice (ECJ). However, failing to renew those bonds at maturity or releasing them onto financial markets could trigger severe financial disturbances, starting in countries with high sovereign debt ratios and then spreading by contagion to the entire eurozone.

Since high sovereign debt ratios are the root cause of this potential source of instability, common policy action may cope with the problem by keeping those sovereigns in public hands outside the ESCB, thus mitigating investors' fears of insolvency. It could also tame systemic banking risks by helping banks reduce their exposure to national sovereigns by providing a liquid 'safe' asset to hold in their place.

Micossi (2020) and Avgouelas and Micossi (2021) have proposed to set up a new facility at the ESM to enable it to gradually acquire the sovereigns held by the ESCB and then renew them for as long as needed to avoid any destabilising effects of their redemption on national public debt markets.

These purchases would be financed by the EMS by issuing its own liabilities, which under appropriate arrangements would become the long-sought after eurozone safe asset, open to European and international investors. This would also pave the way for a larger role for the euro as a reserve instrument in the international financial system (Micossi 2020).

An important feature of this scheme is that it would eventually separate the monetary responsibility for the lending of last resort in the eurozone sovereign debt markets from the fiscal responsibility of ensuring the orderly rollover of sovereign debts that were acquired by the ESCB (on this cf. also Martin et al. 2021). The burden that was, by necessity, placed on the ECB for the orderly management of sovereign debts would be removed, and central bank independence would be fully restored.

The proposal was discussed in workshops held at the European Fiscal Board (EFB), the Banque de France, the ESM, the European University Institute (EUI), and the Luiss School of European Political Economy (LUISS-SEP). These discussions have highlighted serious difficulties with the original scheme, which this note attempts to tackle. It will address these difficulties in the following order: the setup of the new facility and its conditionality (Section 2); the legal feasibility of the proposal under the TFUE and the Treaty establishing the ESM (Section 3); and the possibility for the ESM to leverage its capital and risk management arrangements by the ESM, also in view of the need to preserve its Triple A rating (Section 4).

2. A new ESM facility to purchase sovereign bonds from the ESCB

Avgouleas and Micossi (2021) had originally envisaged that the new ESM intervention would operate within the existing system of the precautionary credit lines provided for by Article 14 of the EMS Treaty (either the PCCL or the ECCL). Accordingly, sovereign purchases by the ESM were seen in our original proposal as a loan to the Member State concerned. Each Member State would apply for financial assistance under the light conditionality envisaged by Article 14 and the new Annex III in the reformed ESM Treaty (TESM)[1] and then its sovereigns would be eligible for purchase by the ESM. Sovereign purchases would thus be undertaken based on individual financial assistance agreements between the ESM and each eurozone member. The ESM would accordingly establish a (monthly) purchase programme of sovereigns from the ECB stretching over several years, gradually building up its sovereign holdings up to a total portfolio equivalent to 20-25 % of the euro area's GDP. The sovereigns of the different Member States would be acquired in the same proportions respected by the ESBC in their purchase programmes (reflecting the ECB capital keys but the ESM would then be free to manage its sovereign portfolio for best returns – provided of course this would not contradict the goal of financial stability).

It is relevant to mention (even if this specific subject matter does not truly belong as part of this paper) the underlying philosophy in terms of the future evolution of the Stability and Growth

[1] Both the PCCL (Precautionary Conditioned Credit Line) and the ECCL (Enhanced Conditions Credit Line) would be granted by the ESM Board of Governors only to Member States 'whose general economic and financial situation is fundamentally strong and whose public debt is sustainable.' Therefore, conditionality would only boil down to certain 'eligibility conditions', basically requiring respect of the Stability and Growth Pact (SGP) and not involving a macro-economic adjustment programme. This conditionality became the subject of a new Annex III on Eligibility criteria for ESM precautionary financial assistance that was approved as part of the recent Reform of the TESM (signed by ESM members in January 2021 and currently up for ratification by national parliaments).

Pact (SGP), which may help place the proposal in its full context. Our premise is that the sovereigns purchased by the ESM from the ESCB would be excluded from the debt ratios relevant for the SGP, since they were incurred by events outside the Member States' control (and thus may be seen as an expression of European solidarity). Therefore, the average debt ratio of the euro area relevant for the SGP would be reduced from its current value of 100 % to, say, 80 %. If one wanted in addition to exclude altogether any aggregate demand from deflation to bring down existing debt ratios, a further step could be to raise the target debt ratio in Protocol 12 of the TFUE from its present value of 60 % to, say, to the same 80 % value[2]. This of course would be highly controversial politically. Special ESM adjustment programmes would still be required, in our view, for countries with debt ratios exceeding 10 % of GDP (at present seven countries have debt ratios about or above 120 %). Countries with debt ratios lower than the new benchmark could be encouraged to reflate. Special measures to strengthen the credibility of the SGP could include direct intervention by the ESM or the European Commission to correct breaches of the agreed targets for public spending and deficits. In all events, our scheme for debt management would not apply to Member States in violation of the SGP. More broadly, credible fiscal discipline within the eurozone would be critical to eliminate the risk that the ESM (gradual) purchase programme creates a situation of *fiscal dominance* whereby the common policy for sovereign debt management would be highjacked to accommodate ever increasing national debts.

Our subsequent discussions with various institutions have highlighted some serious difficulties in the scheme that have been described in the introduction. For one thing, the ESM rules do not currently envisage the contemporaneous resort to both the precautionary credit lines (Article 14) and the secondary market support facility (Article 18). Indeed, Article 14.6 of the ESM Treaty and the ESM Guidelines on Precautionary Financial Assistance (Article 2.1) indicate that precautionary financial assistance can only be drawn via a loan from the ESM or a *primary* market purchase by the ESM directly from the Member State. Article 4.2 of the same Guidelines also requires that a maximum size of the tranche or primary market purchase be set in the initial decision to grant a credit line, a provision hardly compatible with a purchase programme of a very large amount stretching over many years.

At closer look, however, the contradiction between the two instruments from the standpoint of our proposal runs deeper. The precautionary credit line is a credit to a Member State, adding to its net debtor position. On the other hand, buying sovereigns in the secondary market does not affect the financial position of the Member States concerned – except perhaps by changing the risk features of those sovereigns – as the ESM and the ESCB would be trading securities that are already outstanding. Our proposal aims at postponing the redemption of sovereigns and rolling them over through a very long time-horizon; in other words, treating ESM purchases as a credit *vis-à-vis* the Member States would utterly frustrate the entire operation.

[2] Under Article 126.14 of TFEU, the numbers in the Protocol could be modified by the Council by unanimity but without requiring ratification by national parliaments.

A different approach is therefore in order. Fortunately, this is already provided on its own by Article 18 TESM, whereby 'the Board of Governors may decide to arrange for operations in the secondary market in relation to the bonds of an ESM Member, in accordance with Article 12.1.' Article 12.1 in turn provides that 'if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States, the ESM may provide stability support to an ESM Member subject to strict conditionality, appropriate to the financial instrument chosen.' Here, the general purpose of safeguarding the stability of the euro area *as a whole,* as well as that of its Member States, finds explicit recognition. The reference in the ensuing sentence to *an individual* Member State in no way precludes that this type of assistance be granted simultaneously to all the eurozone Member States.

The provisions of Article 18 must be understood in proper context. The TESM was negotiated in the winter of 2011-12, and Article 18 was conceived as a possible way for the ESM to intervene in a sovereign market of a Member State confronting an idiosyncratic financial shock unrelated to its fundamental economic conditions – i.e. precisely what was later decided at the European level with the new Outright Monetary Transactions (OMT) facility of the ECB (September 2012). At that time, European policymakers believed that financial attacks ('speculation') would typically concentrate on one country at a time, as had happened with Ireland and then Portugal. The Six Pack and Two Pack reforms and the so-called Fiscal Compact[3] were already there to seemingly ensure strong fiscal discipline and structural economic reforms.

Since 2015, the rationale behind financial assistance by the European institutions has fundamentally changed: first, with the ECB programmes of quantitative easing (applying to all eurozone sovereigns), then with the ESM facility for pandemic support (lending to all Member States without any condition other than helping alleviate the health situation), and finally with Next Generation EU (entailing common borrowing through the European Commission to help all Member States overcome and recover from the pandemic crisis). In this context, it becomes conceivable that the ESM would intervene in the sovereign debt markets of its Member States. These purchases would not amount to a loan to the Member States but rather would represent a portfolio investment justified by the overriding goal of preserving the financial stability of the eurozone. The sovereigns would be purchased at market price.

Article 18.2 makes it clear that the ESM cannot activate the facility by itself but its interventions 'to address contagion' may only start following an analysis of the ECB 'recognizing the existence of exceptional financial market circumstances and risks to financial stability'. As has been argued, the specific problem that must be addressed is that of preventing the risk of instability and contagion that may stem from the future need for the ESBC to dispose of its sovereign holdings once their monetary policy justification expires. To succeed in this mission, a gradual purchase programme must start long before the materialisation of that risk; it is therefore necessary for the ECB to take upon itself the required long view and the responsibility for

[3] Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, signed on 2 March 2012 and subsequently ratified by the Member States in 2013-14.

activating this ESM instrument in case of a future risk to financial stability that the very existence of the new facility would likely eliminate. This assessment by the ECB would need to take place without a concurrent financial shock or an immediate potential threat to financial stability in the eurozone.

An alternative to our gradual purchase programme that has been suggested by Martin et al (2021) would be a one-shot swap of sovereign assets held by the ESCB with a corresponding amount of new ESM liabilities issued all at once. This approach would not result in the 'one-shot' creation of a large market for ESM liabilities, since all ESM freshly issued liabilities would end up in the belly of the ESCB, which could only release them slowly in a thin market (at present total ESM liabilities circulating in financial markets amount to about EUR 120 billion) and would still be constrained by the need to not perturb monetary conditions with its open market sales. Moreover, a question may arise as to whether the ECB may conduct such a bulk operation exclusively with the ESM that is not likely at market terms (cf. Article 18 of the ECB Statute). A gradual purchase programme that entails small transactions in each case would not be exposed to this objection, as the two institutions could trade between themselves based on an observable market price that would not be influenced by their trades. These considerations have led us to exclude that these trades could take place at the sovereigns' nominal price, as we had originally speculated, and to conclude that only the market price could apply[4].

As to the conditionality to be applied when a Member State's sovereigns are acquired by the ESM, Article 18.3 TESM refers to a memorandum of understanding (MoU) to be drawn as specified in Article 13.3 (as amended by the recent reform). The question arises, in this regard, as to whether it wouldn't be appropriate to refer instead to the new provisions for the precautionary credit lines contained in (amended) Article 14 and the new Annex III, notably with its reference to 'eligibility criteria' to be continuously monitored (by the ESM Managing Director and the European Commission, in liaison with the ECB) which however would normally not entail a macro-economic adjustment programme[5]. Stricter conditionality would apply to countries not fully respecting the SGP, as already provided for in Annex III for precautionary credit lines. In any event, two general criteria would always be respected as a pre-condition for the participation in the scheme, namely that: (a) there is a threat to the financial stability of the euro area as a whole or of its Member States – which would be ascertained by the ECB analysis provided for in Article 18.2; and (b) that the public debt of all countries participating in the purchase scheme would be sustainable.

[4] We had originally considered the possibility that the purchases by the ESM could take place at face value. However, pursuant to Art 18 of its Statute, the ECB is authorised to buy and sell securities on the market under the conditions set out therein, which might be violated by purchases at face value.

[5] In line with Article 14's precautionary financial assistance, Annex III provides that for countries in full compliance with the eligibility criteria, boiling down to full compliance with the SGP and the excessive imbalances procedure, a letter of intent will suffice, while for those not meeting some of these criteria, but 'whose general economic and financial situation remains strong and whose government debt is sustainable', an MoU as specified by (amended) Article 13.3 will be required.

A further question that must be addressed concerns the financial impact on the issuers of the large transfers of sovereign securities from the ESCB balance sheet to that of the ESM. Leaving aside for the moment the positive impact that such operations could bring about for the liquidity and acceptability of those sovereigns, under current arrangements the national central banks earn the interest rate paid by national governments on their national sovereign debt holding. These interest payments in turn are typically returned to their governments together with net central bank profits. The transfer of sovereigns to the ESM would thus entail an immediate loss of revenues for national governments. The numbers involved, however, are not large enough to aggravate sustainability concerns even for countries with the highest debt ratios. For instance, in the case of Italy, these forgone annual gains would amount to less than EUR 7 billion – hardly an amount relevant for debt sustainability. The issue, on the other hand, is irrelevant for ECB profits as both negative and positive interest on their sovereign portfolio typically evens out almost completely every year.

A further question is whether the sovereign purchases under consideration would change monetary and financial conditions. For one thing, the net financial position of the ESCB would not be affected by what in practice would be an asset swap, a neutral change in its portfolio composition. On the other hand, financial market conditions could change as result of the (gradually) increased supply of ESM liabilities (unless of course there was a pent-up demand on the market for these securities). Any such unwanted effect could be easily offset with open market operations by the ECB. Similarly, the pace of monthly purchases by the ESM could be increased to meet the need for higher sales of sovereigns by the ECB for monetary policy operations – thus ensuring that the national sovereign markets would remain undisturbed and open market operations would impact the market for ESM liabilities, which would gradually become the main channel for the transmission of monetary policy.

A final question that must be confronted at this stage is whether the ESM would be legally able to issue the very large liabilities required by our proposed scheme. While limits have been set by the Eurogroup and the Board of Governors for total lending[6], and total credit under individual facilities, no such limit exists presently either for the purchases of Article 18 or the total liabilities to be issued as a counterpart by the ESM – provided that the former are not seen as a loan to the Member States. Appropriate caps could of course be set by the Board of Governors to govern ESM security issues year by year in line with the purchase programme. A separate issue that needs to be tackled is whether a limit to purchases and liability issues is required in proportion to the ESM capital, notably in view of the need to preserve its Triple A rating. We will return to this later.

[6] The Eurogroup statement of 30 March 2012 set an overall ceiling for the combined ESM/EFSF *lending* at EUR 700 billion, out of which the maximum lending volume of the ESM was set at 500 million. However, as we have argued, this ceiling would not apply to sovereign purchases under Article 18 to the extent that these purchases cannot be seen as ESM loans.

3. Legal feasibility under the European Law and the Treaty establishing the ESM[7]

Under our proposal the ESM would purchase public debt securities from the NCBs, acquired before and during the pandemic, and that the ESCB should divest once the monetary policy justification is exhausted. We will now examine whether such an operation can be carried out without modifying the Union and ESM Treaties.

3.1 On the compatibility with EU law

On the basis of general principles of international and European law, the establishment of the ESM and its operations are lawful as long as they do not conflict with the provisions of EU law. This was confirmed by the ECJ in the Pringle judgment[8]. The provisions of the TFEU to be mainly taken into consideration, as indeed in Pringle, are Articles 127 (giving the ECB exclusive competence in monetary policy), 125 (prohibiting the Union and its Member States from assuming the obligations of another Member State – the *no-bailout* provision) and 123 (prohibiting any monetary financing of the Member States by the ECB and NCBs).

Any conflict with Article 127 TFEU may be ruled out immediately. By purchasing sovereigns from the ECB, the ESM pursues non-monetary financial stability objectives, and at all events these purchases only entail a change in the portfolio composition of the ESCB. As has been discussed, repercussions on financial conditions may be brought about by the ESM security issues to finance these purchases, but the ECB possesses the instruments to offset them as required by monetary policy. There may also be repercussions on price trends, but these are secondary effects with respect to a clearly stated economic policy operation. The exclusivity of the ECB in monetary policy is therefore not affected (Pringle, para. 93-98).

Conflict with Article 125 TFEU also does not arise. As stated in Pringle (para. 129-147), Article 125 is not intended to prohibit any form of financial assistance to a Member State, provided two conditions are met: that the beneficiary state remains solely responsible for its obligations, and that assistance prompts the Member State to implement sound policies. In our case, the debtor of the sovereign bonds remains the State that issued them; only the creditor changes, passing from the ECB to the ESM. On the other hand, the preventive and continuous assessment of compliance with the eligibility conditions of the new credit line, created to support ESM purchases, guarantees virtuous behaviour throughout the euro area. Those two conditions therefore appear to be fully satisfied.

Violation of Article 125 must also be ruled out from another point of view. The purchase of the securities may result in losses for the ESM, market gyrations or debt restructuring by the issuing state. Losses may also arise from any ESM loan or other operation. When this happens, the

[7] This paragraph draws heavily on the arguments developed by Tosato (2021).

[8] Judgment 27.11.2012, case C-370/12, specifically paragraphs 99-107.

losses must be borne by the ESM capital. In such cases, it may be necessary to ask the Member States for a supplementary capital payment and a state may fail to provide it. As set out in Article 25.2 TESM, the missing share is provisionally covered by the other Member States, but the obligation of the defaulting state remains valid. Therefore, as clearly explained in the Pringle judgment (paragraphs 144-146), even in this case Article 125 would not be breached.

In our original proposal, we had envisaged the possibility of leaving the default risk of the sovereign bonds purchased by the ESM with the NCB (e.g. by means of some kind of derivative transaction). This was motivated by a desire to avoid the mutualisation of sovereign risks by the ESM. However, we have now realised that this would entail a guarantee by the NCB on the solvency of national sovereigns, and therefore would breach Article 125. Thus, we have dropped this provision and the ESM will have to carry the full risk of its sovereign portfolio. As we shall see later, this does not necessarily endanger the ESM capital.

No conflict also arises with Article 123 TFEU. As pointed out by the ECJ (again in Pringle, paragraphs 125-127), the prohibition contained therein is specifically addressed only to the ECB and the NCB, and therefore does not apply to the ESM. Apart from this observation (which is at any rate diriment), our scheme does not entail any monetary financing of sovereign debts. The ESM buys sovereign bonds from the ECB that the latter has purchased on the secondary market. This does not constitute monetary financing – provided that the ECB's purchases have complied with the conditions set out in the Gauweiler (16.06.2015, case C-62/14) and Weiss (11.12.2018, case C-493 / 17) judgments[9]. The non-existence of an 'upstream' monetary loan by the ESCB *a fortiori* excludes the notion that it can be envisaged for 'downstream' purchases by the ESM.

It is worth noting, finally, that the distinction between purchases by the ESM relating to 'pandemic' securities and other ECB purchase programmes is irrelevant for the legality of ESM purchases as the grounds for compatibility with EU law are the same. The element of 'solidarity' that characterises the former can be relevant from a political standpoint, but not juridically. Therefore, the ESM interventions that we are proposing are fully compatible with Articles 127, 125 and 123 TFEU, regardless of the type of securities involved.

[9] In these judgments, adopted following a preliminary ruling by the German Constitutional Court, the ECJ legitimised the ECB's two programmes entitled the Public Sector Purchase Programme (PSPP) and Outright Monetary Transactions (OMT), but at the same time required that their implementation be adequately motivated, especially with regard to the principle of proportionality (Gauweiler, para. 66-92; Weiss, para. 71-100). The ECJ also established that the purchase of sovereign bonds by the ECB takes place in such a way as to exclude any circumvention of the prohibition pursuant to Article 123 TFEU (Gauweiler, para. 66-92; Weiss, para. 101 et seq.). The Karlsruhe Court conformed, albeit with reservations, to the Gauweiler judgment (Decision 11.06.2016), while it rejected the Weiss judgment, which was deemed lacking on the point of proportionality (Decision 5.05.2020).

3.2 On compatibility with the Treaty on the ESM (TESM)

The ESM was established with the aim of safeguarding the stability of the euro area through financial support interventions in favour of Member States under financial stress (Article 3 TESM). Two main forms of intervention are envisaged: loans to Member States that are already in serious financial difficulty (Article 16 TESM) and precautionary credit lines to prevent such a situation from occurring (Article 14 TESM). In addition, Article 18 provides that the Board of Governors may arrange for operations in the secondary market in relation to the bond of an ESM member.

ESM support is subject to specific conditions (conditionality), some general, others relating to the specific form of intervention. As already mentioned, the former includes the existence of a risk to the stability of the euro area as a whole (and attendant risk of contagion) and the sustainability of the public debt of the beneficiary states (Article 13.1 TESM). The latter range from a macroeconomic adjustment programme, in the case of loans, to continuous compliance with eligibility criteria, in the case of precautionary credits (Article 12.1 TESM)[10].

In our current version, we have envisaged that the ESM intervenes to strengthen the financial stability of the euro area through the secondary market facility in Article 18 TESM, standing on its own and not in connection with a precautionary facility credit line (as we had originally envisaged). There seem to be no preclusions in this sense in the TESM, which considers credit lines as flexible instruments, not bound to particular purposes. They can therefore be used to address various situations which could jeopardise the stability of the euro area. This has been done recently to allow the financing of anti-Covid health expenses (Board of Governors, Decision 5.05.2020), without any objections being raised to the absence of specific conditions for access to the facility (except for its use to combat the health emergency). Of course, use of the Article 18 facility, as we have proposed, should be preceded by an accurate assessment of the eligibility conditions established in the TESM (in our proposal, as specified in Annex III of the reformed TESM)[11]. The important feature relevant for our purposes is that eligibility conditions be assessed *ex-ante*, and then be followed by continuous monitoring of compliance with these conditions once the purchase of the securities has begun.

Ultimately, there seem to be no valid reasons to claim incompatibility between the proposal under consideration and the TESM. However, the decision to enact our proposal has a political dimension belonging inevitably to the European Council and the ESN Board of Governors.

[10] We should recall that Article 14.1 TESM provides for two types of precautionary credit lines: the Precautionary Conditioned Credit Line (PCCL) and the Enhanced Conditions Credit Line (ECCL). The two credit lines differ in the financial status of the beneficiary states (less sound in the case of an ECCL) and in the consequent nature of the conditionality (stricter for the ECCL). The eligibility conditions for access to the PCCL and ECCL are specified in Annex III of the TESM.

[11] On this cf. also the Commission document of 7.05.2020: Pandemic Crisis Support - Eligibility Assessment.

4. Leveraging ESM capital

Under our proposal, the ESM sovereign purchases could eventually rise to 20-25 % of the euro area GDP, or some EUR 2.5-3 trillion. To do so, the ESM would have to issue a similar amount of its own liabilities, thus leveraging its capital – which is about EUR 705 billion – by a factor between 3.5 to 4.3. We must now determine whether this is legally possible under the TESM, as well as whether this would be compatible with the ESM retaining its Triple A rating. We will argue that both questions can be given a positive answer.

On the legal matter, the TESM is clear on the fact that total loans under the ESM and EFSF (until the latter is wound down) cannot exceed EUR 500 billion capital (Article 39 TESM), and in addition that any losses on these loans will be fully covered by ESM reserves, paid-in capital, and called-in capital (Article 25). Accordingly, ESM liabilities under these provisions would not be allowed to rise beyond the total ceiling for lending and the maximum leverage would be well below unity.

The situation, however, appears quite different with respect to our proposed facility. The reason is that in this case the ESM would not borrow *to lend* but to acquire other securities (Member States' sovereigns). Therefore, its liabilities would rise in line with the securities accumulated on the asset-side of its balance sheet. Since these securities are the public debts of its Member States, they may deem to be of the highest quality – and indeed fully safe as long as we can believe that no Member State would be allowed to go into default (as this could wreak havoc to the eurozone financial system and perhaps endanger the very survival of the euro itself).

On this, suffice to recall that during the Greek debt restructuring process by the EFSF in 2017-18, the cost of the operation was charged to the Greek state (in the form of an extra interest charge over interests due by Greece on the loans) and the ESM bore no losses. The ESM constantly refers to this precedent in their presentations to financial investors to solicit their investments in ESM bonds.

Let's assume, however, that we want the ESM to be highly conservative in its financial policies and consider that a share of its capital must be put aside against the risk of the sovereigns purchased from the ESBC and held in on the asset side of its balance sheet. Let's further assume that the main risk on this score is that represented by Italy, whose debt – under the capital keys of the ESBC, would represent about 18 % of total sovereign purchases by the ESM, or between EUR 450 and 576 billion, in our range of total exposure of the ESM following sovereign purchases (between EUR 2.5 and 3.3 trillion). Even in this extreme scenario, the ESM capital (paid-in and callable) would amply suffice to cover the losses of the ESM without further contributions by its Member States (although calling the full capital would certainly make Member States nervous). The condition of full loss coverage implicit in the current TESM formulation could be met. Of course, in a less extreme scenario, with losses on Italian sovereigns amounting to, say, 10 or 20 % of Italy's public debt, ESM losses would be only a fraction of the above losses. And were the Greek EFSF precedent be replicated, which in all likelihood would be the case, the ESM would carry no losses.

In sum, these considerations point to the conclusion that the ESM capital would amply suffice to cover any possible loss due to debt restructuring by a Member State; that the implicit conditions of full coverage of ESM of losses set in the TESM would be satisfied; and that even in this case the ESM would not be allowed to suffer any losses. The likelihood of any event such as a default by a large euro area Member State would in all likelihood be rather slim, given its potential disruptive effects to the euro itself.

The same considerations apply in regard to the financial impact of ESM sovereign purchases on the rating of its liabilities. Since the risk of default of even the weakest of all Member States in tiny, then the Triple A rating of the ESM would not be threatened. Further reassurance on this score would come from the conditionality attached to those purchases, which entails the continuous monitoring of the economic policy eligibility conditions contained for each Member State in its letter of intent or MoU conditioning the activation of the facility.

5. Concluding remarks

We have presented an in-depth review in this paper of the proposal by Micossi (2020) and Avgouleas and Micossi (2021) to transfer a substantial share of the sovereigns acquired by the ESCB, before and during the pandemic, to the ESM. Such an operation is required to avoid the potentially disruptive impact of releasing those sovereigns in financial markets once the monetary policy justifications for the ESCB to hold those sovereigns has been exhausted. Thus, the ECB would be freed from the risk of fiscal dominance and the financial stability of the euro area would be strengthened.

We have argued that the ESM is legally entitled to do this under the TFEU and the TESM as an expansion of its basic mission to preserve the financial stability of the eurozone, regardless of any separate monetary policy justification.

The main operating instrument for this kind of financial assistance would be the purchase of sovereigns by the ESM from the ESBC under the secondary market support facility of Article 18 TESM. With appropriate modifications of Article 18 – which would not require ratification by the Member States – the conditionality applied by the ESM would mimic that already designed for the precautionary assistance facility of Article 14 TESM, as described in the new Annex III of the reformed TESM.

As we have argued, there would be no legal obstacles for the ESM to leverage its capital as required to finance its sovereign purchases and this would not endanger its Triple A rating. The availability in large amounts of the safe asset issued by the ESM would subsequently help strengthen the overall international role of the euro.

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