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SAFE Finance Blog

Last-mile hurdles in the reform of the ESM

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The reform of the ESM turned out to be one of the main political issues in Italy at the end of this year, to the point of posing an existential threat to the sitting government. However, a well-functioning ESM is of vital interest in particular to countries like Italy.



For the first time in Italy's postwar history, a government is at risk of collapse over a decision on a European issue. The dispute is on the reform of the European Stability Mechanism (ESM), an institution created in 2012 during the euro crisis to support Eurozone states in financial difficulty. The reform, meant to be approved at the mid-December European Council, consists of a number of rather technical (but significant) amendments in the ESM treaty whose overall aim is to enhance the institution's intervention capacity.

The Italian government, a coalition between the populist Five Star Movement and the center-left Democratic Party, is under pressure by the opposition represented by the League and the smaller Brothers of Italy to reject the reform. The two right-wing parties, counting together well over 40 percent in recent opinion polls, accused the government of lying on the real content of the deal and betraying the country's interests. Five Star, which until August governed with the League, is divided on the issue, several parliament members remaining sensitive to the League's sovereigntist message. Hence, there is a possibility that the parliament will reject approval of the deal and bring down the government. The League, still resenting their August demise, is blowing in the fire.

ESM is vital for member states with weaker public finances

The circumstances leading to this predicament are surprising and concerning. Surprising is, to begin with, the break with a long tradition in which decisions on European issues were regarded as marginal and usually supported by large majorities with little debate. More attention to Europe would not be a bad thing in itself, except that the circumstances just described suggesting that domestic political motives are, once again, predominant. Surprising is also the fact that critics are raising objections at the last moment, after an 18-month long negotiation during which the stakes have been known all along.

The real surprise and cause for concern, however, is that the entire political debate in Italy is focused now on how the conditions to access ESM resources can be tweaked, not on what the country should do to its public finances to avoid such access in the first place. What is not well-understood is that a reformed and well-functioning ESM (in Italy nicknamed "salva-Statì", or "states-saver"), far from being rejected, should be of vital interest precisely of a country like Italy, with its chronic problem of public finances and lack of market confidence. The ESM is a lender-of-last-resort to states, whose core business is to provide financial support to countries that lose access to financial markets.

Moreover, the reform now on the table enables the ESM to provide a backstop to the Single Resolution Fund, the cash pool available to the Single Resolution Authority, to finance banks in resolution. No less important, a financing agreement with the ESM unlocks, under to the European Central Bank 2012 decision on Outright Monetary Transactions (OMT), the unlimited purchases of the central bank in support of a country's sovereign market. For all these reasons, the existence of a reformed ESM with multiple intervention instruments and adequate resources is indispensable to Italy more than to anyone else.

Financial stability may not always align with the strict lender's interests

To be true, some of the concerns being raised are not unfounded. Together with several good things, the ESM treaty also contains elements, which, if wrongly interpreted and applied, could exacerbate systemic risk. Under the agreed rules, the ESM will flank the Commission in assessing the sustainability of the borrower's public debt. While debt sustainability is a natural condition for financial help, the perspectives of the Commission as guardian of EU common values and rules and that of the ESM (which, as one of the new recitals states, should conduct the assessment "from the perspective of a lender") may diverge. Financial stability, the central statutory goal of the ESM, may not always align with the strict lender's interests.

Risks to financial stability may also arise: for instance, if a newly inserted provision, which facilitates the restructuring of public debt by requiring that collective action clauses on new securities as of 2022 provide for "single limb" aggregated voting, are interpreted in a certain way. Market participants might think that

this is implying that a debt restructuring will from now on be normally required before ESM assistance, rather than being "exceptional" as the treaty itself prescribes. The new text does not offer full comfort against these potentially serious risks.

What may happen now?

As I write these lines, the Italian government is under heavy pressure to ask for a postponement of the ESM decision to link it to the upcoming negotiation on the completion of the banking union. Delaying and broadening the negotiating space may help defuse the political mine in Rome, but is not likely to be of much help otherwise. No significant improvements can be expected at this late-stage on the ESM, a dossier which 18 countries out of 19 are anxious to close as soon as possible. Discussions over the completion of the banking union are still at an early stage and largely unrelated to the ESM. Moreover, delaying tactics are likely to generate frustration and irritation among Eurozone partners. On both sides, a combination of patience and pragmatism (for example, approving the basic text of the treaty while leaving out certain technical aspects for further discussion) may offer the best way out. Exacerbating political tensions in Italy is in nobody's interest at this point.


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