The ***European Stability*** *Fund* as a *Constrained Efficient* ***Mechanism****

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Abstract

A *European Stability Fund* (ESF) designed as a 'constrained efficient mechanism', based on long-term risk-sharing contingent contracts, will be a "robust crisis management" mechanism, which is the main objective of the *European Monetary Fund* (EMF) proposed by the European Commission (6.12.2017). As with the EMF, the set-up of the ESF can, and should, be based on the existing *European Stability Mechanism* (ESM). In fact, the basic element of the ESF, the ESF contract, does not require an institutional change – as has the EMF – but just the introduction of *ex-post* contingent contracts, with the only *ex-ante* constraint of limited – possibly absent– redistribution. By contrast, the existing ESM (30+ years) long-term debt contracts are non-contingent *ex-post*, but are *ex-ante* contingent on austerity/reform programmes. ESF contracts are subject to *limited enforcement constraints* (there is no incentive to default, nor undesired *ex-post* redistribution) and *moral hazard constraints* (to reduce endogenous country risk). This design makes the ESF also suitable for: *i*) risk-sharing among countries with different risk profiles and existing liabilities, as is currently the case in the EU, and *ii*) solving existing 'debt-overhang' problems, given its absorbing capacity.

The ECB, thanks to its design, has successfully solved the time-inconsistency problem of monetary policy – the temptation to raise current prices. The ESF is designed to solve the time-inconsistency problem of fiscal policy – the temptation not to follow efficient countercyclical fiscal policies.

We illustrate all these features by developing a model of the ESF, where the ESF contract is calibrated to the euro area 'stressed countries'. In particular, we show that there are substantial welfare gains from using ESF contracts, as opposed to standard non-contingent defaultable debt contracts, which were at the root of the euro crisis.

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