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Why Meseberg matters

A short explainer of the Franco-German position on euro area reform

Henrik Enderlein
Director, Jacques Delors Institut – Berlin

Lucas Guttenberg
Senior Research Fellow, Jacques Delors Institut – Berlin

In this blog post, Henrik Enderlein and Lucas Guttenberg explain the main features of the Franco-German position on euro area reform as agreed in Meseberg on 19 June. They argue that it is an important step forward because finally the two biggest euro area countries have agreed to jointly ask the right questions for the future of EMU and are signaling readiness to give joint answers to them. In that sense the agreement is not a compromise, but a synthesis of French and Germany views.

1 Why Meseberg matters

Germany and France have agreed on a common position ahead of the European Council next week in a number of policy areas. Most significantly, they have managed to bridge some of their differences on the future of the Eurozone. The Meseberg declaration and the ministerial agreement (in our reading the latter is a more detailed version of the former) are very good news for EMU reform. Not because of its level of ambition – what Germany and France propose falls short of the necessary comprehensive overhaul of EMU architecture as for example proposed in the report of the 14 Franco-German economists. Not because of their level of detail (some parts of the position leave the reader confused and leave ample room for constructive ambiguity), not because they were massively unexpected (the chancellor had already announced many of the elements in her interview and thus prepared the German public), but because finally the two biggest euro area countries have agreed to jointly ask the right questions for the future of EMU and are signaling readiness to give joint answers to them. In that sense the agreement is not a compromise, but a synthesis of French and Germany views.

2 It's politics, stupid – the meaning of the proposed euro area budget

France and Germany have agreed to push for a euro area budget to "promote competitiveness, convergence and stabilization". And more specifically that "there is a need for a genuine macroeconomic stabilization function in the Eurozone, without transfers." When you contrast these two elements with the often quoted non-paper of the German finance ministry published less than a year ago, you get an idea how momentous the shift in the German position is. The paper stated: "A macroeconomic stabilization function e.g. through a new fiscal capacity or unemployment insurance is economically not necessary for a stable monetary union."

The German government has now accepted that there is a role for euro area-wide fiscal policy in both the investment and the stabilization areas. What matters most is this shift in principle, rather than the exact details on which the news instruments will be built. Some observers rightly argue that the actual substance in the proposals on macro-economic stabilization is rather weak – all proposed tools will be loan-based and will not involve transfers, be it the new instrument in the ESM, the proposed unemployment re-insurance fund or the idea to suspend payments to a euro area budget in crisis times. From an economic perspective, we share this view. But from a political perspective what matters is that Germany and France have now jointly asked the question how to best contribute to stabilization and investment in the euro area by means of common fiscal policy. This is new – and this is positive.

The principle to set up a euro-area budget during the negotiations on the multiannual financial framework of the EU could become the starting point for a fundamentally changed EMU. For this to happen, many questions will have to be answered: How big should the budget be? How should it be financed exactly? How will the governance look like and in particular what role will the European Parliament play? How will non-euro area member states react when they discover that the money for the euro area budget will be missing in the EU budget? While answering these questions will prove difficult, the principle that a euro-area budget should be created will remain unaffected by the negotiations. Talking about the *how*, not anymore about the *if* of euro area-wide fiscal policy is the real step forward of Meseberg.

By contrast, the reference to the "European Unemployment Stabilization Fund" still focuses on the question whether such an instrument should be created. France and Germany will set up a joint working group to examine what this Fund could look like. There is a clear red line in the joint document that such a system would work on the basis of loans and not transfers. This suggests that the instruments comes closer to a cyclical stabilization fund than to a real unemployment insurance. But this is actually not a bad idea. If France and Germany agree that the cyclical component of unemployment inside EMU is a common challenge of all euro-area countries calling for a reinsurance system, then this is a major step forward. Clearly, many details need to be worked out. But here again, the message is foremost political; France and Germany accept that cyclical stabilization in the euro area is a matter of common concern that necessitates a common response.

3 Help for the innocent bystander – an ESM reform that could address contagion

As it was expected, the joint position focuses institutionally on the ESM as the locus for reform. This is sensible, not only because changing the ESM treaty was necessary anyway to include the longtime agreed backstop for the Single Resolution Fund (see below), but also because the intergovernmental character of the ESM makes support in Germany more likely – even if many Europhiles would have preferred a federal step and a strengthening of the Commission.

The main objective of the suggested ESM reform is to provide assistance to countries that are hit by market stress without being directly responsible for this. What France and Germany are proposing is quite intriguing: First, one can read the text so that there should be a precautionary instrument (i.e. a country gets access to a credit line based on a number of conditions and only draws on it when necessary) that should be usable based only on ex-ante conditionality – as the text states "without a full programme". This would mean that such an instrument could be deployed for countries that simply adhere to the rules of the governance framework, i.e. the Stability and Growth Pact and the Macroeconomic Imbalances Procedure, and that commit to adhere to the rules in the future. Second, they seem to propose to allow access to such a precautionary instrument even when countries are already experiencing problems with market access – so far a "proven track record of access" to markets is a precondition. Taken together, this could make the precautionary instruments indeed a viable tool to fight contagion. One obstacle to this could however be the continued involvement of national parliaments (read: the Bundestag) in approving such credit lines even when a broader crisis is not imminent.

What is also important is that some other questions are not prominent. The position is very prudent on future rules for debt restructuring. It merely refers to further work on single-limb CACs and to giving the ESM an IMF-like role in facilitating debtor-creditor negotiations. This is a very weak reference to the possibility sovereign debt restructurings can take place in the euro-area. Still, this reference is there, so France and Germany confirm the status quo (restructuring possible in exceptional circumstances) without rocking the boat by going any further.

The joint position is also rather moderate on the institutional front: The ESM should get a bigger role in programme monitoring (which it already de facto has) and should also continuously analyse country performance. The sentence referring to a "compromise" to be found between the new ESM and the Commission highlights that the institutional changes are not uncontroversial, but also suggests that the stronger ESM role should not come at the detriment of the Commission's role. The ESM is not supposed to duplicate the Commission's tasks in economic surveillance as prescribed in the EU treaties. IMF participation in euro area programmes remains an option but judging from the language will no longer be the default assumption.

If France and Germany have made clear that they are willing to open the ESM treaty, there is no clear signal when the Treaty should be closed again. While President Macron spoke about next year, there is no reference in the joint document. The integration in EU law should follow later.

Overall, the reform of the ESM as proposed here could of course have been more ambitious from an economic point of view. It could have included concrete measures to change the protracted governance and could have ended the vetos. But that was politically never in the cards. What is on the table now is a sensible offer to finally make use of the ESM's yet unused battery of instruments in a proactive way.

4 Banking union: on the way towards completion, but not yet fully there

Banking union has been a complicated topic between France and Germany. Neither is particularly attached to it and hence no side is willing to pay a high political price for its completion. But the common position shows: Both have now accepted that there will be a common backstop for the Single Resolution Fund (SRF), the main missing element in the common supervisory and resolution architecture, and both have accepted the need for further risk reduction and say concretely what they mean.

On the backstop, France and Germany clarify three crucial points: First, the backstop will be a credit line from the ESM to the SRF – no surprise here, but important to clarify this once and for all. Second, the backstop can come earlier than in 2024, the date that was originally agreed as latest start date, and both are willing to open not only the ESM treaty but also the so-called Inter-Institutional Agreement on the SRF to make that happen. They also propose a clear process how the backstop can be brought forward: In 2020, the SSM, the SRB and the Commission will determine whether there has been sufficient progress on two fronts, namely the reduction of non-performing loans and the build-up of bail-in-able capital. If yes and if member states agree with the assessment, the backstop can start. Third, they have included an important provision that no country should be excluded from the backstop, i.e. that even if some countries do not fulfill risk reduction targets at all time, they will not be shut off from the backstop. This is the nod to Italy. Where there is still trouble ahead is on the governance: The text states that using the backstop will require a decision of the ESM Board of Governors (and hence likely Bundestag approval) all while making sure that decisions can be taken rapidly. How this institutional puzzle can be solved remains unclear.

On common deposit insurance, the text makes clear that this is not in the cards for now and the near future. Yet, France and Germany see the possibility for a "roadmap for political talks" to be drawn after the summit. This is a baby step towards talking in earnest about deposit insurance.

Overall, the banking union chapter is less ambitious than the two other parts, but it is also more specific. By contrast to the fiscal chapter, on banking union there are fewer symbols, but more concrete policy. Purists could argue that banking union without deposit insurance will never be complete. We agree on the principle. But given the ferocious political opposition to it in Germany, it was wise to put it off – otherwise all the other elements would not have been possible. There is also nothing to address one of the root-causes of the doom-loop between banks and sovereigns, namely the high concentration of sovereign bond holdings in individual countries. But as this point is highly sensitive especially for Italy, it was politically probably very wise not to address it now.

5 Rocky roads ahead

A few final thoughts on where this leaves us:

First, much of the agreement's chance of success will be determined by whether the agreed overarching principles will matter more than fights over details in implementation. The delays in the completion of banking union, the principle of which was agreed in 2012, are a reminder that agreements on goals don't mean agreements on implementation. The Euro Summit next week, will be a test-case in this respect. In the upcoming negotiations on the multiannual financial framework, there could be a constant temptation for Berlin to pit the non-euro area countries against a too ambitious euro area budget by arguing that you cannot have a bigger EU budget and a euro area budget at the same time.

Second, the EU Commission's support for the Franco-German plan is crucial, even if the plans run counter some of the Commission's own ideas. Chances to make rapid progress would increase if the Commission did now what it often does best: facilitate the compromise of member states with useful proposals *after* sufficient consensus has been built. The Commission might be well advised to not to insists on its own EMU proposals as part of the MFF package (which are anyway less ambitious than what France and Germany have put on the table), scrap the proposal on a safe-asset (the SBBS proposal which simply has no political backing in Germany right now) and should instead rapidly come up with workable ideas how to make the euro area budget work. The current set of proposals by France and Germany have some ESM handwriting on them, so now it's time for the Commission to add its own thinking, but without tearing the delicate agreement apart.

Third, we should always bear in mind that the future of this agreement depends very much on the political developments outside the EMU realm. If the German chancellor does not get what she needs on migration, it is likely that her party will also rebel against EMU reform. And if her government unravels (which we consider unlikely right now), so will the whole declaration.

The Franco-German compromise has put the right questions on the table and have shown a path that can be taken. On EMU, the enemy of the good is the better. The good should now be implemented.

Hertie School of Governance