The realignment of the European Stability Mechanism as the centrepiece of euro area reform - speech by Rolf Strauch

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(Please check against delivery)

Dear ladies and gentlemen,

It is a special honour for me to be invited as an economist to this conference for lawyers. Since yesterday, you have covered many relevant and interesting topics: from the community of values, through migration, to Brexit. And now I conclude with the topic of the banking and financial crisis.

The work of the European rescue funds centres on European values, especially solidarity. Often the work of the ESM is seen as an expression of "European solidarity among the euro countries".

How do I come to that conclusion? Without the creation of the two EFSF and ESM bailouts, former programme countries such as Greece, Ireland, Portugal, and Cyprus would probably have had to leave the monetary union.

But this solidarity exists only with the associated "conditionality": the ESM only pays out loans when the recipient country implements deep-seated reforms. In that sense, solidarity is not one-sided, but unfolds within a balanced framework of rights and responsibilities.

The rescue funds raise the money for the loans on the market. Member States take risks in that national budgets are liable for non-repayment. But the programme countries must repay their loans in full, including interest.

With around €80 billion, the ESM has the highest paid-in capital of any international financial institution. This serves as security for investors. The paid-in capital is the reason why the ESM has an excellent rating and pays only low interest rates in the market.

The favourable financing conditions are passed on directly by the ESM to its borrowers. The low interest rates provide significant savings for the respective countries: Greece saved around €13 billion in 2018, for example. That is 7% of Greek economic output. These savings are repeated year after year.

This is the solidarity that I spoke of at the beginning of my speech.

Since 2011, the two rescue funds have lent around €295 billion to Ireland, Portugal, Greece, Spain and Cyprus.

Today, Ireland, Portugal, Spain and Cyprus are experiencing high growth and rapidly declining unemployment. And they can refinance themselves easily on the market again.

At the beginning of this week, Managing Director Klaus Regling was in Athens. He had several meetings there with the new Greek government, including a meeting with the new Minister of Finance, Christos Staikouras. We at the ESM will continue to work closely and constructively with the Greek Government.

In 2010, the temporary European Financial Stability Facility (EFSF) was established; two years later, the permanent ESM.

The ESM was set up for a specific reason: it closed an institutional gap in the euro area. Before the crisis, there was no "lender of last resort" for countries in the euro area.

The rescue funds are part of a broad package of measures, whose interplay ensured success in combating the crisis. Deep reforms in the member states, which received loans from the funds, have largely eliminated their problems. The European Central Bank's (ECB) unconventional monetary policy was an essential element in overcoming the crisis. At the same time, EU-level coordination of economic policies has improved significantly. And the institutional architecture of monetary union has been significantly strengthened by the creation of the two rescue funds and of banking union, and with the latter, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM).We are economically and politically in a state of upheaval. In this context, the question is often raised as to whether we are prepared for the next crisis and what further measures are necessary.

The current economic situation is certainly characterised by a weakening of the growth outlook, but I currently see no reason for recession expectations. For 2019, the growth forecast for the euro area remains unchanged at 1.2%. For the coming year, we expect 1.4%. These values are in line with long-term growth expectations for the euro area. Inflation is projected to reach 1.3% in 2019 and 2020 due to lower oil prices.

However, risks remain on the downside, reflecting a possible further escalation in trade tension, an increase in political uncertainty, and concerns over China's medium-term outlook, as well as the recent intensification of geopolitical tensions in the Middle East and Brexit. Despite everything, I do not foresee a recession but would speak instead of an economic slowdown.

Politically, too, we are in a phase of upheaval. The European Parliament has just reconstituted itself after the elections and now the leadership of the European Commission is also being filled.

Next, both the European Parliament and Commission will determine their strategy for the years to come. In doing so, they can and should – from my point of view – continue to advance the process of deepening monetary union and bringing the reform agenda that has begun to an end.

The ESM remains the centrepiece of this reform agenda, which also includes the completion of banking union, capital markets union, and the establishment of a euro area budget.

Moreover, I believe that we will not be able to advance the deepening of monetary union unless we also think about a more effective structuring of the fiscal and economic policy framework.

Let me now shed some light on the form of the ESM reform before turning to the content.

Two different more fundamental reform approaches for the ESM:

In principle, two different reform approaches were under discussion: on the one hand, the transfer of the ESM to the legal framework of the European Union (EU). And, on the other hand, its development at intergovernmental level as an international organisation.

In December 2017, the European Commission presented a proposal for a Regulation on the integration of the ESM into the EU legal framework. This Regulation was to be based on Article 352 TFEU – the so-called flexibility clause.

Opinions differ as to whether the integration of the ESM can actually be realised by secondary legislation and on this legal basis. Some argue that this requires a change in primary law.

As an economist, I leave the answer to this question to the lawyers. It would be possible to introduce the ESM into the EU Treaties in the same way as the European Investment Bank (EIB). The EIB is an institution with its own capital and a board of directors in which the shareholders are represented. The final decision would remain with the member states and the participation rights of the Bundestag and the other national parliaments would be respected. I think that could be an option in the medium-term. At the moment, the time is not yet ripe.

The shareholders of the ESM, the 19 euro countries, have decided to further develop the ESM on the basis of international law. Some would have liked to see a transfer of the ESM into the EU legal framework.

Let me therefore take the opportunity to dispel some concerns about the current structure of the ESM.

Firstly, EU Member States recourse to international law is seen as a threat to the so-called Community method. Some argue that the decision-making and legislative structures provided for by Union law, and in particular the role assigned to the European Parliament, would be circumvented. Instead, an international treaty would be negotiated in "backrooms" and submitted to national parliaments for ratification.

With a view to the ESM this criticism does not convince. The Community method and the decision-making structures provided for by Union law can only be effective where EU law provides for the possibility of action.

However, as I have just briefly touched upon, there is no consensus on whether the ESM could be integrated into the EU legal framework.

The back room rhetoric seems to me far-fetched. I have seen a very different picture in recent months during the negotiations to amend the ESM Treaty.

It is, of course, right for representatives of the national governments to negotiate the text of the treaty. However, they always kept an eye out for their respective national positions and parliamentary requirements and represented them on the international stage. This also makes sense, because the parliaments are involved after the signing of the treaty and before its ratification in accordance with their respective national procedures.

Germany ensures the Parliament's involvement during the treaty negotiations through the Federal government's constitutional duty to provide information and participation rights to the Bundestag.

Secondly, I also cannot see any democratic deficit in the work of the ESM. The decision-making bodies of the ESM – the Board of Governors and the Board of Directors – are composed of the 19 finance ministers of the euro area and their representatives. The finance ministers are democratically legitimised as members of governments and accountable to national parliaments; also for their voting behaviour in the ESM decision-making bodies. A number of national parliaments, therefore, closely follow what is decided in the decision-making bodies of the ESM and influence important decisions.

Democratic re-integration through national parliaments is also consistent with their budgetary responsibility, since ultimately euro area member states bear the liability risks associated with ESM stability assistance.

Third, the current set-up works well, has proved its value in the financial crisis, and there is no need, therefore, to rush to change it. The key decisions on stability aid are decided unanimously and thus require the approval of representatives of all 19 euro countries. Sometimes this is criticised as cumbersome.

However, when I look back at the past financial crisis, I note that the principle of unanimity has not hindered the ESM from delivering stability support in an efficient and timely manner. The unanimity principle also has important advantages. It ensures that all Member States stand behind the ESM decisions and take responsibility for them.

Fourth, the ESM is anything but completely detached from the European Union. Links between the ESM and the EU are diverse and important. I would like to emphasise in particular the close and good cooperation with the EU institutions and especially with the European Commission.

The ESM Treaty delegates a number of tasks for the design and monitoring of programmes to the European Commission. In particular, the Commission has a role to play in the Memorandum of Understanding, which sets policy measures for programmes to ensure compliance with Union law.

Content-related reform elements

After these general remarks on the form of the reform, I would like to highlight two substantive reform elements, the reform of precautionary credit lines and the increased role of the ESM in future financial assistance programmes.

Reform of precautionary credit lines

How did the reform of the precautionary credit lines come about? The member states wanted to make these credit lines more effective. So far, this instrument has not been used, even though early, precautionary stability aids can prevent small problems from becoming large ones.

Where structural adjustments are needed in the member state concerned, reform requirements may be much less demanding than with ESM loans. ESM loans are accompanied by a comprehensive macroeconomic adjustment programme.

In addition, under the precautionary credit line, ESM funds should not normally be disbursed as the lines of credit are provided only on a precautionary basis. Early stability aid can not only be more promising but also cheaper.

Nevertheless, experience shows that Member States avoid these loans, even if they are under heavy pressure from the financial market. While this is certainly primarily for political reasons, the evaluation of past financial assistance programmes from 2017 also shows that the precautionary credit lines for the member states were associated with uncertainties; especially with regard to the related conditionality. This uncertainty may be the reason that no country has ever applied for a precautionary credit line.

In view of these precautionary credit line advantages, the member states have decided to remove the obstacles identified.

On the one hand, the access criteria for precautionary credit lines are defined more clearly. Going forward, it will be easier for member states to assess whether they meet the access criteria.

On the other hand, it clarifies how conditionality will look in the case of the precautionary credit line (PCCL). PCCL is one of the two forms of precautionary credit line. A Member State that gains access to a PCCL will commit, in a letter of intent, to adhere to the strict access criteria throughout its term.

Additional reforms enshrined in a Memorandum of Understanding are not required, unlike other ESM financial assistance programmes. This further removes uncertainty for member states considering applying for a PCCL. And this also makes sense from an economic point of view. The precautionary credit line thus designed signals to the market that the country has no fundamental structural weaknesses. This seal of approval helps secure market financing. And it protects innocent bystanders, states that are affected by contagion effects from other countries.

The access criteria are formulated so strictly that only member states with healthy economic and financial conditions will fulfil them. By so doing and by the member state’s commitment to respecting the criteria for the entire duration, this also complies with the requirements of the ECJ in the Pringle judgment on the European eligibility of financial assistance, more specifically their compatibility with the non-waiver clause (Article 125 TFEU). Aid to a member state is unlikely, therefore, to affect the incentive of that member state to pursue sound fiscal policies.

Role of the ESM in future financial assistance programmes

Another key reform element is to strengthen the role of the ESM in future financial assistance programmes.

Up to now, the ESM Treaty provides for many tasks related to the granting of financial assistance to be outsourced to other institutions – the European Commission, the European Central Bank, and the International Monetary Fund (IMF).

This concerns, for example, the debt sustainability analysis before the approval of an ESM loan or the task of negotiating the Memorandum of Understanding with the member state concerned (i.e., the reform measures that a Member State promises in return for the financial assistance) and monitoring compliance with these promised reform measures.

In the future, the ESM should also be involved in the performance of these tasks. In addition to the European Commission, the Managing Director of the ESM will sign the Memorandum of Understanding in future.

In the future, the ESM should fully contribute its expertise gained during the last financial crisis. This is also important as it is not clear to what extent the IMF will be involved in future programmes. The IMF has reduced its financial commitment over the past programmes and ended up not participating in the third financial aid programme for Greece.

It also makes sense to involve the ESM as a creditor institution. Finally, these are tasks to ensure that at the end of the day the recipient member state will be able to pay its debts to the ESM.

Despite the ESM’s greater involvement, the Commission remains involved in ESM financial assistance programmes in the future, also to ensure that ESM conditionality is compatible with Union law. In addition, of course, it makes sense to continue to draw on their extensive expertise in the many areas in which the reform measures can fall.

What the cooperation between the European Commission and the ESM in the execution of these financial assistance programme tasks will look like in detail can be found in the joint position of the two institutions from last November.

ESM as the backstop for bank settlements

In addition to the reforms that I have highlighted in detail, the ESM will take over the backstop for bank settlements in banking union.

This final safety rung makes sense if the SRF’s funds prove insufficient. Again, there will be no additional financial burden on taxpayers. By 2024 at the latest, the final protection should be fully operational.

Holistic picture: euro area reforms

The ESM reforms described are embedded in the general reform agenda of the euro area. These also include the completion of banking union. In particular, the third pillar of banking union is missing: a single European deposit insurance.

There are still controversial discussions among the member states. Some want to tackle the risk reduction first, others are in favour of risk sharing directly. But I think it is important that we take on European deposit insurance within the framework of banking union – even if the issue remains controversial.

Earlier this year, the High Level Working Group was established. It will identify a possible way forward for achieving deposit insurance and will deliver a second report to the Eurogroup in December. The new President of the EU Commission has also spoken out in favour of European deposit insurance.

In addition, finance ministers are currently working out the details for a euro area budget. This is intended to promote convergence and competitiveness in the currency area.

Conclusion

Let me come to the end now.

I think it is not an exaggeration to call the ESM the “centrepiece of euro area reform”. The work of the ESM has played a decisive role in overcoming the euro crisis.

The reorientation of the ESM serves on the one hand to consolidate its role as a permanent rescue institution, but also to curb small fires before they develop into a conflagration. We are currently working hard on it, and with great conviction.

Thank you very much.

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