The response to the Covid-19 crisis and remaining vulnerabilities in EMU

View PDF
10/09/2020
Speeches
ESM
Berlin, Germany

Klaus Regling, ESM Managing Director,
“The response to the Covid-19 crisis and remaining vulnerabilities in EMU”
Article published in *Eurofi Magazine*, 10 September 2020
Eurofi Financial Forum, Berlin

Eurofi Magazine: What are the economic vulnerabilities of the European Monetary Union that have been amplified by the Covid-19 crisis (increasing heterogeneity of economic performance following the pandemic, temporary suspension of the Stability and Growth Pact leading to increased divergences in fiscal performance, further lack of capital mobility among Member States…)? What are the priority policies required to repair the Monetary Union and the related key success factors? To what extent, should the EU’s new €750 bn Recovery Fund contribute to address these vulnerabilities?

Klaus Regling: It is six months since the Covid-19 virus reached Europe in March. Although the economic recovery has been fairly strong since May, 2020 will register the deepest recession in 100 years. Economic activity will not reach pre-crisis levels before 2022. Europe reacted quickly to the economic consequences of Covid-19 with a strong and concerted response.

Shortly after the viral outbreak, the European Commission activated the General Escape Clause, temporarily suspending the EU fiscal deficit rules of the Stability and

Growth Pact, and facilitated the implementation of state aid. The European Central Bank contained euro area fragmentation by significantly expanding its asset purchase programme with the Pandemic Emergency Purchase Programme.

In July, the European leaders took a historic decision by agreeing on an instrument called “Next Generation EU” that will boost the next EU budget. To finance this package, the Commission will borrow money on financial markets on behalf of the EU, through the issuance of bonds. Money will start flowing in 2021.

This Summit decision was preceded by a first support package with three safety nets that are all available now: one for sovereigns provided by the ESM, one for businesses provided by the European Investment Bank and one for workers provided by the EU Commission. These safety nets can immediately provide up to €540 billion and are designed to help the most affected countries.

All these measures at the European level in response to Covid-19 - which come on top of significant national measures in every EU member state - are important to limit the economic and financial damage of Covid-19, to protect the EU Single Market and to maintain a level-playing field.

These measures at the European level are also welcome from the perspective of monetary union as they are designed to prevent economic divergences among euro area countries and can also contribute to a stronger international role of the euro. However, they do not make a further deepening of EMU obsolete. The euro area is where Europe has integrated most economically and financially – and it is the main focus of global investors, analysts and market participants.

The agenda for deepening EMU, which we discussed during the last few years, remains valid: completing banking union, creating a capital markets union, setting-up a fiscal capacity for macroeconomic stabilisation and completing the ESM reform.

One important element of the ESM reform is the backstop to the Single Resolution Fund (SRF). If SRF resources are depleted, the ESM can lend the necessary funds to finance a bank resolution. The backstop - together with some form of common deposit insurance - would complete banking union, leading to more cross-border risk-sharing through the private sector. Progress on capital markets union would facilitate cross-border equity investments and provide new ways of funding for companies. All this would improve the allocation of capital in EMU, thus enhancing its growth potential and making the euro area more attractive to international investors.

In addition, a permanent fiscal stabilisation mechanism for euro area countries will be needed eventually. A central fiscal capacity to stabilise economies would help to avoid excessive divergences between euro area countries and can avoid small problems from becoming big problems. It would also reinforce investors’ confidence in the euro area’s capacity to respond to future crises. While the “Next Generation EU” is the right response to the Covid-19 crisis, it is a temporary measure for all EU countries. What is needed for the better functioning of our monetary union is a permanent stabilisation instrument for the euro area. Such a facility would not be an annual budget - there will be many years when it is not needed - but a revolving fund, to be repaid within a cycle. With the revolving fund replenished, money can be used again in the next crises for another country.

A fiscal capacity would be particularly useful because countries that are members of EMU have given up two key macroeconomic policy instruments: monetary policy and exchange rate policy. Only fiscal policy remains available to counteract if necessary. The ESM, which has recently diversified its toolkit with the Pandemic Crisis Support, could add such a shorter-term facility to its range of instruments. This would help countries bolster national buffers, giving them more fiscal space in a crisis. The institution has sufficient firepower left for this task even after using the Pandemic Crisis Support.

For the moment, priority is of course to fully operationalize the recovery instruments and focus on implementation. But we should not lose the longer-term perspective and keep working on a robust euro area structure. Starting to work on a stabilization facility now would allow creating an insurance mechanism for the years to come.

Finally, the important role of a European safe asset is more and more recognised. It would facilitate the transmission of monetary policy throughout EMU, allow Europe’s banks to reduce their holdings of national sovereign debt, and strengthen the international role of the euro.

The measures taken in response to Covid-19 can increase the amount of European debt issued by the Commission, the EIB and the ESM from €800 billion to almost €2 trillion. Together with sovereign debt issued by highly rated euro area countries, the amount of safe assets would increase to around 40% of euro area GDP over the coming years, compared to 90% in the United States.

Eurofi Magazine: What should be the characteristics of a renewed and effective Stability and Growth Pact once the crisis is over? Should new rules be added? What measures would finally make it effective? Is it a prerequisite to move toward a Fiscal Union?

Regling: Let me stress that despite its complexity, the Stability and Growth Pact has worked better than most people believe. In 2007, before the Global Financial Crisis, the aggregate fiscal deficit in the euro was 0.6% of GDP. Japan, the United States and the United Kingdom had deficits of 3% to 4% of GDP in the same year, while all countries were in a similar cyclical situation. Just before the pandemic, the euro area was again doing significantly better than the rest of the world, providing more fiscal space when the crisis broke.

However, the Pact needs to be reformed to become more credible again. Simpler and more effective rules and procedures would help stabilise and guide policy-making and market views. Investors have little faith in the current framework with its many exceptions. And one should not blame the European Commission for that, these exceptions were decided by the Member States. Now it has become too complicated.

The other reason why a reform of the Pact is needed, is that one of the key variables used to assess fiscal policy, the “structural” balance, is not observable but must be estimated. That requires estimating the output gap and potential growth rate of every euro area country.

Before the Global Financial Crisis, a fairly reliable system existed for making these estimates. Since 2009, this approach does not work any longer. We should therefore seize today‘s unique situation – with the EU fiscal deficit rules suspended for 2020 and 2021 - to agree on an improved, simpler and more credible fiscal surveillance framework. This will not be easy but is also a pre-condition for making progress on more fiscal risk-sharing in the euro area.

The Commission presented in February a review of the effectiveness of the economic surveillance framework, launching a public debate on its future, which is a good start. The European Fiscal Board has made very useful recommendations in this context, focusing more on observable variables, including debt sustainability and the growth rate of expenditures.

A more credible fiscal surveillance framework and more fiscal risk sharing would present additional steps towards a fiscal union, on top of the measures taken during the last 10 years in the context of the euro crisis. But we do not need, in my view, a full political union nor a full fiscal union to make the euro area function smoothly. The European Union is unlikely to become the United States of Europe but we should continue to work towards strengthening the EU, and deepening the euro area in a few specific areas, fully respecting the principle of subsidiarity, thus bringing more prosperity to Europeans, making EMU less vulnerable and strengthening the international role of the euro.

Author

Klaus Regling
Managing Director

Contacts

Cédric Crelo
Head of Communications and Chief Spokesperson
+352 260 962 205
c.crelo@esm.europa.eu

Anabela Reis
Deputy Head of Communications and Deputy Chief Spokesperson
+352 260 962 551

a.reis@esm.europa.eu

Juliana Dahl
Principal Speechwriter and Principal Spokesperson
+352 260 962 654
j.dahl@esm.europa.eu

George Matlock
Senior Financial Spokesperson
+352 260 962 232
g.matlock@esm.europa.eu