Diario Economico Conference "What have we learned from the crisis?"

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What have we learned from the Euro area crisis?

Lisbon, January 12 2015 - Klaus Regling, Managing Director, ESM

Good morning. It’s great to be back in Lisbon again – I have been here many times in the past few years though the last time I spoke at a public event like this was in October 2011.

Today’s conference is very timely. As Portugal has exited its EFSF programme last year, it is now a good moment to reflect on what happened during the euro area crisis and what lessons we should learn. The way we at the EFSF would like to be perceived, is as a long-term partner to Portugal. The EFSF is the country’s largest creditor, our loan with the longest maturity will be repaid in 2040. Therefore, the EFSF has a stake in Portugal’s success and it’s in our interest to make that success sustainable.

I will structure my thoughts around three topics.

First, I will start by giving you my perspective of what happened in Portugal and why – despite the remaining difficulties - I consider the country’s successful exit from the financial assistance programme something the Portuguese should be proud of.

Second, I will turn to the question of what lessons we can draw from the Portuguese and, more generally, the European experience of the past five years.

And third, I will finish on what I believe still needs to be done in order to lock-in our achievements in the euro area and to perpetuate our currency union’s more robust shape.

One: Less than 4 years ago, Portugal was unable to borrow at sustainable interest rates and that's where my institution stepped in. From May 2011 to last April, the European Financial Stability Facility – the EFSF - disbursed €26 billion euro to Portugal. This was one third of the overall assistance package, with another €24.3 billion from the European Financial Stability Mechanism (EFSM) – an EU facility funded through bonds issued by the European Commission – and a further €26 billion from the IMF.

The EFSF's contribution was in the form of long-term loans that have an average weighted maturity of almost 21 years and at interest rates that are only slightly above the EFSF's cost of funding. Interest rates vary when we issue bills and bonds to finance our loans. But thanks to our excellent rating and the investors' confidence, the rates are very low. Typically, we pay a little more than Germany and a little less than France.

I do know that for many Portuguese, the past years were painful. Salaries and pensions were cut, public expenditure was reduced, and many lost their jobs. I am fully aware that this was a traumatic period for Portugal and that many still feel it today. Unfortunately, given the level of imbalances accumulated in Portugal during the preceding decade, serious adjustment was needed. Let me recall 2 that our financial assistance actually helped to ease that pain. EFSF loans – together with the loans of the EFSM and the IMF – helped to buy time for this necessary economic adjustment. Had Portugal not been able to rely on its partners, the adjustment would have been much more brutal because it would have happened overnight.

Additionally, the EFSF's very favourable lending conditions – low interest rates and long maturities - generated savings of €1.27 billion for the Portuguese budget in 2013 alone. That is the equivalent of 0.8% of GDP or 1.7% of total primary expenditure. And these savings are not a one off. Portugal can expect continued budgetary savings for many years to come.

These benefits are a result of favourable lending conditions. Structurally, the benefit of this adjustment is coming from the reforms implemented as a condition for the loans: a credible fiscal consolidation strategy to get the debt/GDP ratio on a medium term downward path, structural reforms across all sectors of the economy to boost potential growth, create jobs and increase competitiveness; and a stabilisation of the financial sector through both recapitalisation and deleveraging.

This strategy allowed for a rapid correction of imbalances. As labour costs were significantly lowered, the external account moved from a substantial deficit into surplus and the budget deficit has more than halved.

The programme also allowed for the repair of the financial sector in Portugal. It did so within the limit of €12 billion earmarked for recapitalisation. Investors have rewarded these efforts. Portugal has now convinced the markets of its creditworthiness and has regained access to long-term debt financing. Yields have fallen from 16.6% in January 2012 to below 2.5% last week for 10 year bonds – a drop of 14 percentage points.

The real economy is also showing encouraging developments. 2014 was the first year that positive GDP growth was recorded since 2010: 0.9%. And in 2015, GDP growth is projected to be above the euro area average. Domestic demand, notably private consumption, has strengthened.

Macro-economic indicators in Portugal show that the growth and job perspectives are good if reforms continue. As noted in the European Commission country specific recommendations, Portugal should take additional policy action, for instance, to complete the restructuring of state owned enterprises, take further measures to tackle high youth unemployment and continue its fiscal consolidation.

All EU countries should follow these recommendations, not only Portugal. It’s worth emphasising the process itself: First the Commission proposes these recommendations, then each country has an opportunity to respond and finally the entire package is endorsed at a European Council by the leaders of member states. Consequently, these are recommendations endorsed by the entire EU and there can be no excuse not to implement them.

We have already seen some setbacks. The Commission’s post programme monitoring report mentions a reversal of some of the measures that contributed to fiscal consolidation in recent years. The deficit target of 2.7% may be missed this year, leaving Portugal under an excessive deficit procedure. This would be a bad signal.

The good news is that the most difficult part of the adjustment with significant wage, pension and public spending cuts are history. What matters now is to make sure that structural reforms and consolidation of public finances are being sufficiently advanced to lock in achievements, so that the Portuguese economy can continue to reap the benefits of increased competitiveness.

Two: Let me now turn to the question: What we can learn from the Portuguese experience as well as the experience of other euro area countries that got into difficulties after 2009? All these lessons are closely related to the fact that we are in a currency union with a single monetary policy and now 19 member states that implement their economic and fiscal policies in a decentralised way at the national level. A crucial lesson we had to learn is that in this situation, countries cannot sustain large divergences in competitiveness over an extended period of time. One key indicator to look at is the development of unit labour costs in the five countries that later entered into an EFSF or ESM programme. In Portugal, Ireland, Greece, Spain and Cyprus you clearly see that their costs spiked spectacularly in comparison to Northern European countries. The result was a significant loss of competitiveness that was reflected in large current account deficits. In order to correct this situation, painful cost-cutting was unavoidable as national devaluation was no option in the euro area.

Another lesson concerns sound fiscal policy. The programme countries were vulnerable from the markets' point of view as they had deficit and debt levels that investors considered unsustainable. The advantage of having solid budgets can be observed in countries like the Netherlands and Finland. Both countries have had their economic problems for some time. However, markets never lost confidence in these states, because their budgetary situation is considered sustainable.

The benefits of reducing costs will only show up fully if they are accompanied by structural reforms. Opening and liberalising product and labour markets with the aim of increasing and improving labour productivity and labour utilisation is key. The countries with programmes have done a lot here but the movement must continue. This is a difficult process, because governments need to take on vested interests. But the reward is worth the effort. In its "Going for Growth" survey, the OECD ranks the reform efforts of its 34 member states. Among the top five, are four countries with an EFSF or ESM programme. Portugal is ranked in fourth position – ahead of Spain and only out-ranked by Greece and Ireland among the programme countries.

Another important lesson of the crisis concerns the institutional design of the currency union. When the euro area was set up, nobody could imagine that member states could lose investor confidence and market access. The European Central Bank did many things during the crisis to support the currency union. Just remember, the SMP government bond purchasing programme, the Long-Term Refinancing Operations and the OMT announcements and their role in maintaining the stability of our currency union. However, the ECB cannot play the lender of last resort for euro area member states. Monetary financing for individual states is prohibited in the euro area - for good reason. It is only with the EFSF and the ESM, the euro area’s crisis resolution fund, that this institutional gap was filled.

With the combined EFSF and ESM financial firewall of €700 billion, there is now a credible backstop for member states in difficulties that reassures the market. Investors are impressed that the euro area now has a crisis resolution mechanism that has disbursed €232.5 billion to five countries in less than four years. By the way, that is three times as much as the IMF has disbursed globally in the same period. I think it is fair to say that without the EFSF and the ESM, some euro area countries would today no longer be part of the currency union. Their departure would not only have been a huge risk 4 with enormous potential cost for the concerned country and for the whole euro area. It would have also changed and, perhaps, even destroyed the Europe that we know.

Another lesson is that the way we oversaw economic and budgetary policy in the euro area was just not up to the task. The crisis clearly showed that the existing rules and coordination mechanisms were insufficient. In the absence of joint decision-making, it is necessary to have strict debt and deficit rules, less room for political interference, and balanced budget rules in the national legal systems. In addition, procedures to correct macroeconomic imbalances and increased powers for Eurostat, the EU statistical authority, significantly improved economic policy coordination in the currency union.

The last lesson is that the founders of the currency union had neglected to create a truly integrated European banking market. Supervision continued at the national level although all large banks were operating across borders. Trust in the European banking system eroded. The establishment of a Banking Union was overdue. Since November, the Single Supervisory Mechanism has been responsible for the supervision of over 120 of the biggest banks in the euro area.

And we also learnt a lot from our own mistakes. Crisis management involves taking decisions in realtime, so we have to recognise that we didn’t always get it right.

Here are some examples where procedures improved as the crisis progressed:

- To allow countries more time to achieve the fiscal adjustment, the timeline to meet the 3% deficit criteria was extended separately for Portugal and other countries, such as Spain.
- Conditions of EFSF loans were improved through both maturity extensions and interest rate reductions. For Portugal, the repayment period was extended by an extra 7 years from the initial 15 years to help borrowing countries to regain debt sustainability.
- A system for bailing-in bank creditors didn’t exist when Ireland needed support for its banking sector. However, it had been created in time for use in both Cyprus and for BES here in Portugal.

Three: It is fair to say that we have achieved a lot in the euro area. Should we congratulate ourselves and lean back? Obviously not. There is no room for complacency. While it is undeniable that we have come a long way in improving our rules and coordination mechanisms, it is also clear that more integration in the euro area would make our currency union more robust and less vulnerable. I believe one can argue that with more integration we would have suffered less during the crisis.

What does this mean in concrete terms? I am convinced that our improved rules and coordination mechanisms are important and useful steps. Probably this was the maximum that was possible to achieve in a crisis. If these rules are fully applied, our monetary union will function much better after the crisis than before the crisis.

It is beyond the scope of my presentation today to outline a detailed road-map of what I think should be done. But let me give you a few hints. I personally support the creation of an EU budget commissioner with real powers. I would argue that this commissioner should be empowered to reject national budgets if they are clearly in breach of agreed rules and if they risk creating negative spillover effects on the rest of the currency union. It would not be the commissioner’s task to plan alternative national budgets. But he or she should be in a position to ask national parliaments to decide on a budget that is in line with the agreed rules.

The creation of such a position would have another advantage. As our rules and coordination procedures were strengthened and refined during the crisis, they have now become so complex that even experts find it hard to understand. For “normal” citizens, the number of acronyms and jargon words is impossible to follow. Just think of the “six-pack”, the “two-pack”, the “European semester”, the “macroeconomic imbalance procedure” and so on. I believe this is a good reason to move from rules to common decision-making, and to strengthen our institutions.

Also, we should think about joint decision-making for structural reforms. As I explained earlier, the lack of structural reforms can lead to sustained divergences that can develop into a threat for the financial stability of individual countries and of the euro area as a whole. In such cases, joint decisionmaking among euro area member states to initiate and implement necessary structural reforms would be a big step forward.

The December 2012 report “Towards a genuine Economic and Monetary Union” written by the presidents of the European Council, the Commission, the Eurogroup and the ECB addresses these issues. I am glad that the heads of state and government tasked the four presidents to present a follow-up report at the European summit in June this year.

I am aware that most of these ideas would require change to the EU Treaties and I am aware of the political difficulties and complexities this implies. Legitimacy would also need to be strengthened if and when more sovereignty is transferred to the European level. Nevertheless, it is important to begin this process, to make our monetary union even more robust and successful.

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