Fiscal integration and financial assistance in Europe: the ESM experience - speech by Klaus Regling

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(*please check against delivery*)

Good afternoon.

I am happy to be joining you today from Luxembourg, where the European Stability Mechanism has its headquarters. I have been asked to speak to you about fiscal integration and financial assistance in Europe, two topics which are very much at the core of what the ESM stands for.

Of course, the question of just how much fiscal coordination and integration the euro area needs has been a hot topic since the launch of Economic and Monetary Union

(EMU) 30 years ago. After all, EMU has always been innovative in the sense that it combines a fully centralised monetary and exchange rate policy with decentralised fiscal policies. Many academics argued in the 1990s that this could never work. The response of EU policy-makers was that it could work as long as national fiscal policies are coordinated appropriately.

Looking back, one can distinguish three phases during which the approach to fiscal coordination and integration evolved:

- The first phase was defined by the concept of the Maastricht Treaty, which was maintained during the first decade of monetary union.
- The second phase of fiscal integration lasted from the euro debt crisis until the onset of the Coronavirus pandemic.
- The third phase describes the current situation.

Let me say a few words on each of these three phases of fiscal integration and coordination in Europe and conclude with some thoughts about a possible future fourth phase which could complete the deepening of EMU.

The first phase: from the Maastricht Treaty to the financial crisis

The decision to form an Economic and Monetary Union was enshrined in the Maastricht Treaty that was prepared and negotiated from 1988 onwards and signed in 1992. At the time, EU leaders recognised that further economic integration and, in particular, a common currency was needed to protect the single market and maximise its benefits.

The Maastricht Treaty introduced convergence criteria that had to be met **before** a country could join Economic and Monetary Union. The two famous reference values of 3% in terms of GDP as the deficit limit and 60% for debt were adopted to ensure debt sustainability of all participating countries. These figures were not selected at random. They made sense in light of nominal GDP growth and the average debt levels at the time of the Maastricht negotiations. Policymakers were aware of the risks that irresponsible fiscal policies could pose for the entire euro area, particularly if they originated in large countries.

But the convergence criteria were only relevant for joining EMU. It was not clear how fiscal policies would be coordinated **after** the launch of the monetary union. That’s why the Stability and Growth Pact was developed in the mid-90s which operationalised the 3% deficit limit and the 60% debt target. This meant that the existing fiscal criteria in the Maastricht Treaty, which countries were expected to meet **before** monetary union, were complemented with rules to be respected continuously **after** the launch of monetary union.

The rules of the Stability and Growth Pact were simple at the time: They specified that each country should aim for a balanced budget under normal cyclical conditions or, to put it differently, on average over the course of a business cycle. The aim was to have fiscal space in a recession, when the fiscal deficit could increase by up to 3% of GDP to allow national governments to implement countercyclical policies. In addition, there was always an escape clause that allowed more significant deviations in a crisis.

In the 1990s, 3% of fiscal space was considered sufficient for dealing with most business cycles. We know now – as we often have to deal with financial crises - that more fiscal space may in fact occasionally be necessary, but at the time, 3% was considered adequate.

In particular, the implementation of the pact after the launch of EMU in 1999 turned out to be highly procyclical. Most governments did not use unexpected revenues in cyclical upturns to reduce deficits and the period of economic growth in the late 1990s was not used to create sufficient buffers. As a result, dealing with an economic downturn either required a counterproductive procyclical tightening or a violation of the prescribed fiscal deficit limits. This is precisely the choice Germany and France faced in 2002 and 2003, when both countries ended up breaching the fiscal limits of the Stability and Growth Pact.

However, instead of strictly applying the rules to Germany and France, which could potentially have resulted in sanctions, other countries supported the two fiscal sinners in 2003. Financial markets did not react to this erosion of the rules and it was broadly recognised that the Stability and Growth Pact needed to be reformed.

The subsequent reforms resulted in a more sophisticated pact which allowed more leeway for economic judgement to take cyclical elements into account. However, the greater flexibility of the new pact also made it more complex and harder to understand.

During this early phase of monetary union, there was another important element of fiscal integration that is often forgotten: fiscal transfers. Fiscal transfers have been a core element of European integration since 1957. This happens via the EU budget, where richer countries pay in more than they receive while poorer countries are net recipients. Although the EU budget is small - roughly 1% of EU GDP - the transfers that go to poorer countries are huge: 3-4% of their respective GDP every year. Of course, these transfers were not created because of EMU, they existed long beforehand, but they are important for the smooth functioning of EMU.

To summarise, the key elements for fiscal coordination and integration during the first decade of EMU were the Stability and Growth Pact - which allowed counter-cyclical fiscal management, had an escape clause for crisis and became more complex over time - and fiscal transfers.

The second phase: from 2010 to 2020

The second phase of fiscal integration and coordination occurred between 2010 and 2020. After the global financial crisis in 2008-09, which affected almost all countries around the world, the euro debt crisis started in late 2009 and required significantly more fiscal integration and coordination in the euro area.

Greece, Ireland, Portugal, Spain and Cyprus either lost market access or had to pay very high interest rates for newly issued public debt that threatened their debt sustainability. When Economic and Monetary Union had been set up a decade earlier, it had been unthinkable that an EMU country - after having met the difficult convergence criteria - could subsequently lose market access.

Therefore, there was neither a crisis mechanism nor an institution in place that could provide emergency financing to a government that had lost market access. Of course, we had the IMF which, however, had insufficient resources to do so for a member state of the monetary union. The ECB was also not able to help directly because of the prohibition of monetary financing. As it turned out, the euro area simply didn’t have a lender of last resort for sovereigns.

This is why euro area countries first started to support Greece with coordinated bilateral financial assistance in early 2010. The temporary European Financial Stability Facility was swiftly set up later that same year and in 2012, the permanent European Stability Mechanism, the ESM, was created. These institutions filled a gap in the institutional architecture of European and Monetary Union. Together, they provided loans of €295 billion to five countries. Without these loans, some countries would probably have been forced to leave the euro area.

In addition to creating these crisis resolution mechanisms, this second phase of integration saw the beginning of banking union which introduced EU-wide banking supervision and a common resolution mechanism for ailing banks. The Single Supervisory Mechanism (SSM) was set up for systemically important banks in the euro area; it was accompanied by the Single Resolution Board (SRB) and the Single Resolution Fund (SRF). This is relevant for integration as it can lead to more risk sharing between euro area counties.

More broadly, the financial crisis revealed weaknesses in the EU's economic governance and surveillance. In a union of highly integrated economies, effective policy coordination is necessary to prevent a build-up of unsustainable macro-economic imbalances and to ensure convergence and stability.

In response to the crisis, the EU therefore took a wide range of measures to strengthen its governance. Surveillance and coordination were intensified and broadened beyond fiscal and broader macroeconomic policies. Frameworks such as the European Semester, the Six- and Two-packs and the Macroeconomic Imbalances Procedure were developed and implemented.

Since then, for example, euro area countries present draft budgetary plans to the European Commission early on in their budget cycle as part of an annual cycle of coordination and surveillance of the EU's economic policies. In addition, the European Commission makes suggestions to every EU member state on reforms that are designed to raise the growth potential of each country.

To summarise, a lot happened during the second decade of EMU: new institutions were created that had been unthinkable earlier, like the SSM, the SRB, the SRF and the ESM. And broader and closer surveillance was introduced.

The third phase: the present

Let me now turn to the situation we are in today. The measures we took ten years ago are now proving very useful as they provide us with a stronger institutional framework and improved tools to deal with the current pandemic.

At the same time, it is important to note that we are in a very different context today compared to the financial crisis. This time, we do not need to correct excessive macro-economic imbalances in the euro area. Instead, we are responding to a common external shock for which governments are not responsible.

In response, the EU has rolled out a large support package of €540 billion to support workers, businesses and EU countries. As part of this, the ESM offers all euro area countries a precautionary credit line of two percent of their GDP to cover direct and indirect healthcare costs related to the pandemic. This ESM support for countries complements support for companies provided by the European Investment Bank and support for workers by the European Commission. At the same time, a special ECB monetary policy programme (PEPP) continues to stabilise markets.

In addition, the extraordinary €750 billion ‘Next Generation EU’ recovery fund is designed to boost investments and reforms in all EU countries to mitigate the impact of the pandemic on economic growth and to finance the digital and green transition.

The €540 billion package as well as the €750 billion “Next generation EU” package are particularly intended to help those countries more that are most affected by the pandemic. This represents an unprecedented degree of solidarity in Europe. It also protects the Single Market and prevents greater divergences in the euro area, which is in the interest of all.

These packages will require the issuance of new bonds by the European Commission, which will increase the volume of safe European assets significantly - from around €800 billion before the pandemic to around €2 trillion in the coming years. Even though this package will be temporary, it certainly constitutes a landmark in European integration. However, providing transfers to member states in need is not really new. As I explained earlier, transfers via the EU budget have always been part of European integration to strengthen cohesion. Of course, the volume of transfers is now getting much bigger than ever.

European integration will be deepened even further this year with the broadening of the ESM’s mandate. After ratification of the amended ESM Treaty, the ESM will act as a common backstop to the Single Resolution Fund. This is also an important additional step towards the completion of the banking union.

In addition, the reform gives the ESM a stronger role in future economic adjustment programmes and crisis prevention. In collaboration with the European Commission, the ESM will design, negotiate and monitor future assistance programmes.

So, again, a lot is happening right now concerning the further integration of Europe.

The fourth phase: complete the deepening of EMU

Despite everything that has happened since the euro crisis 11 years ago – and that is a lot more than people expected at the time - I would argue that a few more steps are needed to complete the process of EMU deepening. Let me mention the key points on the agenda, some of which are fairly controversial among our member states:

- First of all, banking union should be completed with a common deposit insurance and identical rules for banking supervision.

- Second, we need to make progress on capital markets union.

- Third, the Stability and Growth Pact needs to be reformed.

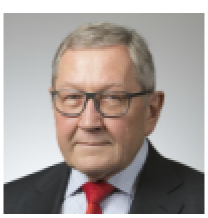
- And finally, we should create a fiscal capacity for macro-economic stabilisation.

All these measures would represent additional steps towards a fiscal union. In my view, they would be useful for making EMU more resilient in a future crisis and less vulnerable. They would also promote the international role of the euro, which is increasingly important for European sovereignty.

That said, I do not believe that we will have a full fiscal union in Europe any time soon. If we had a full fiscal union – together with a political union – we would be the United States of Europe, which is not what the majority of people wants. Nevertheless, many steps towards a fiscal union have been taken in recent years and EMU functions much better as a result. It would function better still after a few more steps which we will now discuss.

Thank you.

Author



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