

Speech at the Global Financial Stability Conference - The Role of Regional Financial Firewalls in Safeguarding Financial Stability: a European Perspective

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“The Role of Regional Financial Firewalls in Safeguarding Financial Stability: a European Perspective”¹

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(Please check against delivery)

Good afternoon Ladies and Gentlemen,

Many thanks for the invitation of the Korean Ministry of Strategy and Finance and the Korean Development Institute.

This morning speakers and panellists extensively discussed the growing economic and financial interconnectedness in the global economy and its impact on the

international monetary system (IMS). Given our earlier conclusion that risk of spillovers have increased considerably, a Global Financial Safety Net composed of several lines of defence seems indispensable for the resilience of the IMS.

Based on the European experience in resolving the euro area crisis, I would like to share with you my view on how Regional Financing Arrangements (RFAs) can provide solid firewalls to safeguard regional and global financial stability.

1. EUROPEAN FIREWALLS' ROLE IN RESOLVING THE EURO AREA CRISIS

At the height of the European debt crisis, markets cast serious doubt on the stability of the euro area and the single currency. **Fortunately, Europe reacted quickly and proposed a comprehensive package of bold reforms, including the establishment of strong financial firewalls - the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM)** [SLIDE 1]. With a combined lending capacity of €700 billion, the EFSF and ESM played the role of lender-of-last-resort for the sovereigns in Ireland, Portugal, Greece, and Cyprus via macroeconomic adjustment programmes. Against conditionality set by European institutions and the IMF, the EFSF and ESM provided liquidity to these countries when they lost market access. The ESM also assisted Spain but only for bank recapitalisation. Since 2011, the EFSF and ESM together disbursed €262 billion to the five programme countries, almost three times what the IMF disbursed under its General Resources Account during the same period [SLIDE 2].

When receiving assistance from the EFSF and ESM, beneficiary countries pledge comprehensive reform packages to correct macroeconomic imbalances and structural weaknesses in their domestic economies. As a result, they have reduced unsustainable fiscal deficits, restored competitiveness, improved current account balances and implemented structural reforms. Growth in Ireland and Spain outpaced the rest of Europe in 2015. Greece, Ireland, Portugal, and Spain climbed into the top five of the OECD's 34 Member States for implementing structural reforms. In 2016, the euro area achieved another important success in Cyprus, the fourth country to stage a successful programme exit following Ireland, Spain, and Portugal. This is a testimony to the effectiveness of our cash-for-reforms approach. Greece remains work in progress, but it can also succeed if it sticks to the reforms it has promised.

Having said this, I must emphasise that the successful resolution of the euro crisis resulted from a comprehensive package of measures. In addition to the European firewalls, Member States adopted courageous structural reforms and conducted fiscal consolidation to reduce macroeconomic imbalances. The crisis also accelerated a complete overhaul of the framework for economic policy coordination in Economic and Monetary Union (EMU). Member States must now adhere to more comprehensive and binding rules, and better coordinate national budgetary policies through the so-called “European Semester.” The new Macroeconomic Imbalance Procedure constitutes an additional tool of surveillance to prevent and correct risky macroeconomic imbalances. Moreover, the euro area banking sector has been strengthened thanks to the construction of the Banking Union and fresh capital injection. Finally, the European Central Bank (ECB) adopted unconventional monetary policy measures to ease credit conditions and help turn around market sentiment.

2. COMPARATIVE ADVANTAGES OF REGIONAL FINANCING ARRANGEMENTS

In my view, RFAs are especially important in a currency union, such as the euro area. This is because Member States of a currency union have particularly strong economic and financial interlinkages. Therefore, as the nominal exchange rate is not available as a shock absorber, a local shock in one Member State can quickly propagate and affect other members. **Moreover, in EMU, the ECB can only provide emergency lending to banks,** as the Treaty on the Functioning of the European Union legally forbids monetary financing of sovereigns. **However, as the last few years demonstrate, sovereigns may also need a lender-of-last-resort when they face tail liquidity risks.**

Based on this experience, let me highlight three potential advantages of RFAs:

First, RFAs can mobilise far more resources than the IMF. Greece is a clear example. In three different programmes, Greece received €223.6 billion² from its European partners, some 127% of Greek GDP.³ The IMF contributed half as much as European countries to the 1st Greek programme and 1/10th to the 2nd. Nevertheless, the IMF loans to Greece in terms of Greek quotas are among the biggest in the Fund’s history. Criticism makes it difficult for the IMF to provide sufficient funds alone to a highly integrated economy in a deep crisis, particularly if this economy belongs to a currency union.

Second, RFAs can provide specific tools to address regional problems

[SLIDE 3]. In Europe, where bank-sovereign feedback loop was particularly strong, the ESM developed dedicated tools for bank recapitalisation. The ESM can either provide indirect loans to Member States' governments for bank recapitalisation, or in exceptional circumstances, directly recapitalise banks. The IMF cannot do sectoral lending and therefore could not help finance Europe's programme for Spain. It provided technical assistance in this case.

Third, RFAs can be more flexible with their lending terms. In the euro area, we provide long-term financing to countries that need to correct large imbalances, with average maturities of 20-30 years [SLIDE 4]. EFSF and ESM also have low funding costs, of below 1% currently for the ESM [SLIDE 5], which we pass on to the countries that borrow from us. Our rates are significantly lower than the IMF's [3.5-5% depending on the amount and duration of the support]. These favourable lending terms reflect a high degree of regional solidarity and generate substantial budgetary savings [SLIDE 6], which reached 5.1% of the Greek GDP in 2015. These savings are crucial for programme countries to regain market access and debt sustainability.

3. CONCLUDING REMARKS: LESSONS LEARNED FOR A SUCCESSFUL IMF-RFA COOPERATION

To conclude my remarks, let me put those lessons we learned from crisis resolution into the broader context of the Global Financial Safety Net (GFSN).

On the one hand, RFAs' comparative advantages must be embedded in sound and efficient cooperation with the IMF, which has wider representation, established surveillance and monitoring capacity, and a global role at the centre of the International Monetary System.

On the other, in the face of new challenges in the global economic context, any single layer of the GFSN seems to be insufficient to provide macroeconomic and financial stabilisation alone. This calls for effective and efficient cooperation between the different layers of the GFSN, in particular between the IMF and RFAs.

Based on the European experience, I think successful cooperation between

the IMF and RFA can build on three fundamental elements: commitment to collaborate, consistency in conditionality setting and operational complementarity [SLIDE 7].

First, strong political commitment to cooperation is key. The founding documents of the ESM embody this view. At times, the technical interaction between the European institutions and the IMF were complicated by their independent procedures and shareholders' views. The ESM represents 19 euro area countries, which are relatively homogenous in terms of economic interests and political constraints. The IMF, in contrast, has 189 countries and often needs to balance their differing views. Progress was ultimately achieved as all sides were committed to cooperation.

Second, cooperation in individual country cases must be based on a similar programme approach and consistent policy conditionality. Coordination failure with respect to conditionality could lead to fragmentation of the IMS and could provide wrong incentives to programme countries.

Finally, at the operational level, the assistance provided by different institutions can vary and even complement each other, especially regarding the instruments, financing conditions and speed of activation. Coordination among institutions could facilitate quick liquidity provision in case of emergency and generate synergies for resource allocation.

Together with my colleagues from other RFAs, I will be happy to continue exploring ways for better coordination. I truly believe that a strengthened and well-structured framework for cooperation between the IMF and RFAs, and among RFAs will trigger a positive learning process among all institutions. This will help us improve our own policy frameworks and will lead to a more effective GFSN.

Thank you very much for your attention.

1 I would like to thank Gong Cheng for helping me prepare this speech.

2 This amount includes €52.9 billion from Greek Loan Facility (GLF), €141.8 billion from the EFSF and €28.9 billion from what the ESM has disbursed so far.

3 In terms of 2015 GDP.

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