# OpEd for the South China Morning Post

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16/01/2017
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**Klaus Regling, Managing Director of the European Stability Mechanism**
**Hong Kong, 16 January 2017**

Europe’s sovereign debt crisis was a stark reminder that modern market economies can still be shaken by such highly disruptive events.

The period of upheaval, which is now well behind us, was preceded by what some might argue was an earlier crisis of similar scale: the collapse of US subprime mortgage markets.

And while Asia survived these two crises relatively unscathed, the continent too has known periods of severe financial turmoil. Everybody still vividly remembers the Asian financial crisis of 1997.

Financial crises are traumatic events not just because of their tremendous economic cost. They damage people’s trust in the financial system and governments. It may take many years before confidence returns.

How this unfolds depends on the economic and structural causes of the crisis, which are different in each case. Ultimately what counts are the lessons that policymakers draw from the events, and the measures they put in place to reduce the chance of a next crisis.

The euro area has pushed through a number of important innovations since its most recent crisis. This has put the currency union on a stronger footing, both in the area of policy coordination as well as in its institutional architecture.

Countries that needed emergency financing have also done their part by reducing fiscal and trade imbalances and implementing structural reforms.

The euro area has, for example, granted the European Commission greater macroeconomic surveillance powers. The unorthodox policy measures by the ECB are another example.

Important new institutions have also been set up in the area of prudential supervision.

Last but not least, the European Stability Mechanism (ESM), a lender of last resort for sovereigns – which I manage – permanently fills a gap that used to exist in the Monetary Union's institutional framework before it was set up in 2012.

The establishment of the ESM, a permanent facility to assist euro zone countries in resolving crises, was preceded by a similar Regional Financing Arrangement (RFA) in Asia in 2000, the Chiang Mai Initiative, later the Chiang Mai Initiative Multilateralisation (CMIM).

There are parallels between the two, which can offer us today some conclusions about what the future could hold for both regions.

In its short existence, the ESM has become a cornerstone of Europe's response to the crisis. It contributes to financial stability in Europe and globally. It has disbursed €US$280 billion in rescue loans to five euro zone countries – three times as much as the IMF globally in the same time span.

Four of these five countries are now success stories: Ireland and Spain, for instance, have among the highest growth rates in Europe. Greece remains a special case, but it can also make a successful exit from its programme, while Portugal and Cyprus have successfully exited their respective rescue programmes.

Like with the IMF, any financial assistance provided by the ESM is based on strict conditionality – this is our "cash-for-reform" approach. But there are also important differences. One is that the lending costs that the ESM charges are only roughly a third of those of the IMF.

Secondly, the euro area countries which are the shareholders of the ESM consider themselves long-term partners of their neighbours in need of support.

The fact that the ESM can provide loans with exceptionally long maturities at favourable conditions provides crucial fiscal space.

Greece, for instance, saves €8 billion ($8.5 billion) per year thanks to these beneficial loan conditions, or 4.5 per cent of its GDP. The recently agreed short-term debt measures are a further sign of this financial solidarity. They will reduce the country’s debt-to-GDP level by 20 percentage points by the year 2060.

The ESM finances its loans directly in financial markets by issuing bonds and bills to investors. With an issuance volume of €US$60 billion this year, the ESM is one of the biggest non-sovereign issuers in euros in the world.

Our debut on the dollar market expected later this year is a sign of how we are continuously adapting our funding instruments to widen our investor base, reduce costs for our borrowing countries, and guarantee liquidity across the yield curve for investors. Asian investors are crucial for the ESM and account for the largest investor base outside Europe.

Our lending to five countries over the last six years has made the ESM – together with its predecessor, the European Financial Stability Facility (EFSF) – the world’s largest RFA.

I already noted that it is not the oldest, however. The Chiang Mai Initiative evolved from a network of bilateral swap arrangements among central banks into a single contractual agreement in 2010, reaching a total size of $240 billion in 2012, and now covers 14 countries and regions in East and Southeast Asia. Other RFAs exist in Latin America, the Middle East, and Central Asia.

The European experience teaches that several factors are important if an RFA is to play a successful role as an institution preventing and resolving crises.

First, it needs to conduct effective economic surveillance to detect warning signals sufficiently early and provide a clear programme design. In Europe, these tasks fall under the responsibility of the European Commission. An RFA also needs to have access to sufficient funding at favourable conditions

Another important issue is that any RFA needs to contain moral hazard risks, and make proper use of regional resources, while at the same time standing ready to swiftly respond to a regional crisis. A key difference between the ESM and the CMIM is that the latter cannot tap financial markets.

The ESM is collaborating with the independent surveillance unit of the CMIM, the ASEAN+3 Macroeconomic Research Office (AMRO).

Last October, these two institutions, together with their Latin American sister institution, the Fondo Latinoamericano de Reservas (FLAR), organised a first high-level dialogue to discuss programme design, lending toolkits, the setting of conditionality and cooperation among RFAs, as well as between RFAs and the IMF, which also attended the meeting.

Such international cooperation adds to the strengthening of what is known as the Global Financial Safety Net, or the sum of national foreign reserves, bilateral swap lines, IMF resources, and those of the RFAs. It is now a common understanding among G20 countries that RFAs are a robust layer of protection in the Global Financial Safety Net.

Financial crises can be triggered by a number of factors, and can take different forms. Macroeconomic fundamentals, consistency of macroeconomic policies, market sentiment and the balance sheet structure of private entities all need careful monitoring.

We don’t need to ask ourselves if another crisis will hit the financial system. It will – either in Asia, Europe, or America.

We just don’t know when: in months, years, or not for another lifetime.

When it comes, it is reassuring to know that the world has been working on a defence system that is becoming more robust and that should dampen the worst of its consequences for citizens.

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