Klaus Regling in interview with LIDER (Croatia)

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Interview with Klaus Regling, ESM Managing Director
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LIDER: Can you explain the role of the European Stability Mechanism (ESM) and how it works within the Economic and Monetary Union?

Klaus Regling: The ESM is the rescue fund of the euro area. It can lend money to euro area countries if they face severe financial difficulties. During the last 10 years, the ESM, and its predecessor, the European Financial Stability Facility (EFSF), supported five countries with €295 billion. Ireland, Portugal, Greece, Spain, and Cyprus were able to finance themselves through our loans. They reformed their economies and improved their competitiveness, thereby regaining the confidence of investors. This does not cost European taxpayers any money, because the ESM raises the money it needs in financial markets by selling bills and bonds to investors.

The ESM has evolved alongside the monetary union. It has been a bumpy ride, especially after the euro area crisis when many were questioning the survival of the common currency. How has the role of the ESM evolved?

Today, the euro area is more robust and better equipped to deal with future crises, also thanks to the ESM and other institutional innovations. During the past crises, the euro crisis and the pandemic, Europe has shown it can be agile by creating financial instruments meeting the requirements of each specific crisis. Financial support from the ESM can be tailored to a range of difficulties: from full stability support programmes to short-term credit lines.

The ESM will have a larger mandate. A big change will be that it can lend money to the EU body in charge of resolving banks when there is a serious problem. This will help banks to be wound down in an orderly manner without spending taxpayers' money to bail them out.

The pandemic wreaked havoc both on a fiscal and monetary scale. Looking back, do you think the EU handled the crisis well? Were there things that could have been done differently?

When the pandemic reached Europe, EU policymakers reacted swiftly with policy actions that helped its member states. This also calmed markets, because financial markets were positively impressed by the speed, volume, and good coordination of the different European measures.

The ESM together with other European institutions quickly agreed on measures, worth €540 billion, to lessen the burden for countries and their citizens. This complemented the enormous efforts that each country took nationally. The €800 billion Next Generation EU (NGEU) recovery plan came on top of this. All these measures were designed to provide more assistance to countries most affected by the crisis. It was essential to protect the EU single market and to avoid divergences in the euro area.

In my view, all these measures were adequate and necessary. They helped to limit the economic damage of the pandemic. They also showed an unprecedented degree of solidarity.

Would you say that the unprecedented stimulus contributed, for example, to the inflation we are now experiencing, as some claim?

In Europe, not really. It is important to understand what the sources of the inflationary shock are. Disruptions in global trade, caused by the pandemic, resulted in supply bottlenecks. Most importantly, rising energy prices contribute about 2/3 to the recent price increases. This means that a large part of the current inflation is “imported”. The policy response has only contributed a rather small share, if at all, to inflation.

The analysis is different for the United States. The US fiscal response to the pandemic was larger and not well targeted. It fuelled demand and allowed the supply shock to translate into more persistent inflationary pressures. Europe’s approach was different: a large part of the fiscal response was designed to strengthen the supply-side of our economies and the money will be disbursed over the next four years. We also do not see second-round effects in the EU labour market so far. Such effects can lead to even higher prices.

How can the Economic and Monetary Union (EMU) be made more resilient to better withstand shocks in the future?

Our monetary union would become much more robust with a fully completed banking union and a fully developed capital markets union. Not only because it would strengthen growth, it would also increase risk-sharing within the euro area.

A fully integrated financial market would dampen cyclical divergences among member states through counter-cyclical flows in the financial markets.

This “risk-sharing” via markets is particularly important for the euro area where we do not have a common tax and social security system that would help to avoid fragmentation. The more risk is shared via markets, the fewer mechanisms are needed on the public side.

For the euro area, there are other, additional options to share risks, like through a central fiscal capacity for macroeconomic stabilisation. We can call it a Stability Fund. Such a fund could make additional financial resources available to countries hit by a sizeable external shock if the national fiscal space turns out to be insufficient. Under the current economic circumstances, it may be more important than ever before. The ESM could provide a Stability Fund.

Banking union is indeed part of that equation, and still has not been completed. Where are we in creating a fully functional banking union?

Two out of the three Banking Union pillars are in place: the Single Supervisory Mechanism that oversees European banks and the Single Resolution Mechanism, which handles the winding down of the operations of a bank in serious financial trouble. This second pillar will be further strengthened when the ESM becomes the backstop to the EU bank resolution mechanism, lending it money if there is a severe banking crisis. But we are missing the third pillar, a common system that can guarantee people’s bank deposits. The President of the Eurogroup that brings together the 19 finance ministers from the euro area every month, is preparing a working plan to make progress on banking union.

There is a lot of talk about the international role of the euro. It is officially the second currency of the world, but it’s a far cry from the dollar. What would make it more attractive in global terms?

There are several things that can be done to strengthen the international role of the euro. The euro’s strength is ultimately that of its economy. Therefore, reforms to improve the growth potential of euro area member states are crucial. As I said, stability and resilience across the monetary union also needs to be enhanced through completing the banking union and capital markets union. Creating a permanent public risk-sharing mechanism, which is currently quite controversial among our member states, would also help. All this would also make the euro more attractive for international investors and enhance its use globally.

The use of sanctions is making other countries wary of the dollar and the euro, which is counterproductive when it comes to making the euro more attractive globally. The dollar has seen a steady decline for the past 20 years as the latest research shows and many are now questioning if the sanctions will only speed up the rise of other, non-Western currencies.

What is your take on this?

The US dollar is likely to remain the dominant global currency. There is simply no other currency with comparable breadth and depth in its financial markets.

Nevertheless, there seems to be a gradual move towards a multipolar system. This is good news for Europe and for the international financial system. A more diversified mix of global currencies would allow borrowers and investors, particularly in emerging markets, to diversify their assets and liabilities, which would reduce risks.

We see already a shift in trade invoicing away from the US dollar towards the euro and the renminbi. The share of the euro in foreign exchange reserves increased from 19% in 2016 to 21% in 2021, and its share in global payments rose from around 33% in 2018 to about 38% in February this year. The international role of the renminbi is still low but has been rising strongly the last few years, particularly in trade financing.

There may indeed be some geopolitical considerations after the recent sanctions. Central banks might think more carefully about how and where they hold their reserves. This could lead to more diversification, also to smaller currencies.

There has been a lot of discussion on the future of EU’s Growth and Stability Pact (SGP). It was suspended during the pandemic. Following the war in Ukraine, we are witnessing a shift even in the thinking of the ‘hawks’ saying that rules have to remain ‘loose’ for longer. Do you see the SGP being changed permanently and in what way?

Even though the SGP has worked reasonably well, it needs to be reformed. The current framework with its complexity and many exceptions is hard to understand for policymakers, the public and financial markets. The SGP’s main elements date back to its introduction in the 1990s and they do not reflect the changed macroeconomic environment. Interest rates, for example, will not remain as low as they are today, but they will remain lower than at the time of the negotiation of the Maastricht Treaty. This means that higher debt targets could be acceptable. I am not saying that countries don’t need to be careful when it comes to debt. The key objective of the SGP – ensuring debt sustainability in all countries at all times – remains valid.

A credible fiscal coordination framework is essential for our monetary union. The main reason is that the overwhelming part of fiscal policy in the EU is conducted at the country level. This will not change, even if the size of the EU budget were to increase or other fiscal mechanisms at the euro area level are introduced. Under such circumstances, fiscal coordination is essential to avoid negative spillovers and to maintain debt sustainability in all euro area countries. I hope we can use the time in which the EU rules on budget deficits are suspended to agree on a simpler and more credible pact.

Now we have the war in Ukraine. How is it affecting the economy and the euro? Do you fear that we are going into recession?

How much growth will slow down will depend on how the war evolves. Higher energy and food prices are reducing real income; uncertainty and new interruptions in supply chains have already caused a deterioration in investor and consumer confidence. Growth this year will be considerably lower than previously expected.

But there are also some positive effects. Growth was strong at the beginning of this year as we moved out of the Covid lockdowns. Countries in Europe are implementing additional reforms, supported by financing from the NGEU fund. This strengthens the growth in our economies, and it supports investments in our future (i.e., the green and digital transformation of economies). Also, consumers accumulated a sizeable stock of additional savings over the past two years. These additional savings can help cushion the decline in real income to some extent.

Can the fiscal arm prevent this alone? The monetary arm is moving towards tightening, leaving national budgets, already heavily strained by the pandemic, to fight on.

Higher prices mean that central banks need to focus on keeping inflation in check. I see this as normalisation of monetary policy, not as tightening.

National fiscal policies can cushion the adverse effects of the increase in energy and food prices on the most vulnerable with well-targeted policies. Beyond that, reforms supported by the funds from the NGEU fund are ongoing and can be particularly helpful under current circumstances. Overall, we have to be aware, unfortunately, that the increase in energy prices implies a transfer of wealth from Europe to energy-producing countries that cannot be compensated.

How do you see Croatia's preparations for the euro?

Adopting the euro as its currency is an ambitious endeavour but it brings many benefits for Croatian citizens and the economy.

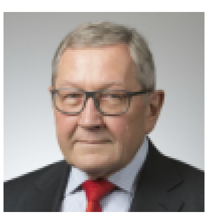
Citizens will feel some benefits directly; for example, they will not need to change money anymore when they travel within the euro area. Other benefits they will feel indirectly. The euro is the world's second most important currency and that will support foreign investment into Croatia. Being part of the euro area sends a positive signal to investors and lowers barriers for firms to do their business in Croatia.

Since 2020, Croatia is already in the "euro waiting room", the exchange rate mechanism. This is one of the four Maastricht or convergence criteria. The other three criteria are equally important, they all have to be met.

The European Commission and the European Central Bank will publish their assessments in June. If all criteria are met, the Council will then take a decision on the next steps.

When Croatia joins the euro area, it will also become a shareholder of the ESM and be represented in its decision-making bodies, which determine the most important matters related to the ESM.

Author



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