Klaus Regling at 16th Walter Eucken Lecture

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’Ordnungspolitik’, the monetary union and the ESM
16th Walter Eucken lecture
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Introduction

Dear Professor Feld, ladies and gentlemen,

Let me first express my warm thanks for the invitation to hold the 16th Walter Eucken lecture at the Walter Eucken Institute in Freiburg. It is a pleasure and honour for me to address you this evening.

As an economist who studied in Regensburg and Hamburg, I have been familiar with Eucken’s works as long as I have dealt with economic issues. Naturally, Eucken’s work “Grundsätze der Wirtschaftspolitik” was an important part of my economic toolkit. And, as a young man, I could see with my own eyes how strongly Eucken’s school of thought influenced economic policy, in the time of the “Wirtschaftswunder”. From my time at the German Finance Ministry, and also from my current position, I know full well the degree to which ‘Ordnungspolitik’ and ordoliberalism determine economic thought in Germany even to this day. Your institute very successfully contributes to this remaining the case, and that is something that I welcome.

In my opinion, Eucken’s core principles - such as the principle of open markets, the subsidiarity principle, the liability principle and the importance he attaches to a stable monetary value - are essential pillars of a well-functioning economic order both at the national and the European level. But what I like most about Eucken and the Freiburg school of thought, which he influenced, is that the main goal for Eucken and his pupils is a “humane and workable economic and societal order”.

On the other hand, I worked many years abroad, at the International Monetary Fund in Washington, D.C. and in Asia, with the European Commission in Brussels and, since 2010 at the European Stability Mechanism in Luxembourg. This has made me aware how difficult it can be to familiarize people outside Germany with Eucken’s thinking. In some languages, there isn’t even a word with which to translate ‘Ordnungspolitik’, and it’s often left untranslated in English texts.
But a closer look shows that Eucken’s principles have had more influence on the European policy framework than most Germans and our European partners suspect. The most prominent example are the basic elements of the Maastricht Treaty, which are modelled on the central principles of ordoliberalism. These include the principle of open markets, the EU internal market - which secures the four basic freedoms - the subsdiarity principle and the liability principle, which finds its expression in the no bail-out clause. Furthermore, the European framework stresses the independence of central banks. This presence of such important Walter Eucken principles means that this European rule set is also ultimately focused on human values.

In what follows, I would like to make four points about Europe, the monetary union and the ESM.

- First, I would like to explain why the ESM’s rescue strategy has been successful.
- Second, I would like to remind you that the functioning of the ESM and our stability programmes are fully covered by German and European law.
- Third, I would like to make clear why countries were acting out of their own economic, political, and strategic best interests when they created the euro and the ESM – Germany in particular.

- Fourth, I will conclude by suggesting how to make the monetary union more robust with a few tangible and limited steps.

Why the ESM's rescue strategy is a success

Let me first say something about the rescue strategy of the ESM. So far, ESM and its temporary predecessor the European Financial Stability Facility or EFSF, have paid out €265 billion in emergency loans to five countries: Greece, Ireland, Portugal, Spain, and Cyprus. When I say emergency loans, this of course means that programme countries need to fully repay those loans with interest. We don't give away money, although it is true that we take on risk. When granting credits, we are following the same principle that has proven its value over decades at the IMF: money only flows once a programme country's government has successfully implemented the required economic reforms that were agreed at the beginning of the programme. The reform menu ordinarily features budget consolidation, structural reforms, and financial sector repairs. Believe me when I say that these reforms are often painful for the population. Governments often have to overcome enormous political opposition to make the reforms happen.

Ireland, Portugal, Spain and Cyprus successfully ended our reform programmes within the agreed time frame, normally three years. Our loans gave these countries the time and the fiscal room for manoeuvre that they needed to make their economies competitive again and to solve problems in the financial sector. All our former programme countries are real champions in implementing economic reforms, studies by the World Bank and the OECD show. Such efforts are worth making for the countries and their citizens: Ireland and Spain, for instance, have the highest growth rates in the euro area, and the numbers in Portugal and Cyprus are also good. Unemployment in these countries is clearly on the way down. The former programme countries contribute to the fact that the euro area now is solid and dynamic again, and does not need to shy away from comparisons with other large currency regions.

Greece is a special case among the five programme countries. Nowhere else were the problems so serious, and nowhere else was the government's ability to act so weak. On top of that, the country marched in the wrong direction under Finance Minister Varoufakis for a period of six months in 2015. Those are the reasons why, even now in the seventh programme year, our stability efforts have not yet been completed. In the current ESM programme, we have disbursed around €30 billion to

Greece out of a total programme of up to €86 billion. From the beginning of the first programme in 2010, the total now stands at €174 billion euro. The ESM programmes runs until August 2018, but I do not expect that the country will need the total remaining funds of around €55 billion in that period. And that means we'll probably stay clearly below the programme maximum of €86 billion.

Particularly in Germany, I'm hearing over and over again that nothing happened in Greece in the past years. This is an unacceptable distortion of the facts, and an insult to the Greek people, who have had to accept cuts in wages, salaries and pensions that would have been unimaginable in Germany. So let me stress that Greece has made considerable progress. The budget trajectory is particularly noteworthy. In 2009, the budget deficit was more than 15 percent of Gross Domestic Product (GDP). In 2016, Greece had achieved a budget surplus of 0.7 percent. Only Germany and three other EU countries had a surplus that was somewhat higher. Such a consolidation success would have been impossible without fundamental reforms. Germany should value that.

Reforms in the public administration – which now employs a quarter fewer staff - in the pension system, the labour market and the banking sector were among the most important structural reforms in Greece during the EFSF and ESM programmes. They were the reason that the OECD pointed to Greece as the reform champion among all OECD member countries in its "Going for Growth" study. The World Bank, the World Economic Forum and the Lisbon Council think tank reach similar conclusions, using different methods.

The Greek programme can successfully be completed in as far as the government implements the agreed reforms. If that is the case, the government could also be able to issue government bonds next year again at the latest, just like its predecessor government did twice in the middle of 2014. Our extremely favourable lending conditions - with lending rates of one percent and maturities of more than 30 years – will enable Greece to get out of its current deep crisis, without causing costs for the taxpayers in other countries.

To repeat: determined programme implementation is a necessary condition for successfully ending the programme. Without that, countries will not be willing to provide further debt relief to Greece after the end of the programme in 2018, should this still be needed by then.

Why the ESM programmes are in accordance with German and European law

Now let me talk about my second point and explain why the work of the ESM and its assistance programmes are compatible with German and European law. Time and again I hear the argument – particularly in Germany - that the establishment of the ESM and its rescue programmes have made the euro area into a transfer union. This notion is often connected to the complaint that we are operating in a legal grey zone. Some even say we are breaching EU law, in particular the so-called no-bailout clause in the Maastricht Treaty. So let me explain why such accusations are wrong.

Before I enter into legal territory, it might be useful to remind you how the ESM operates. In granting credit, we copied the IMF: cash for reform. But when funding our loans, the ESM operates completely differently than the IMF, which gets the money for its loans through the central banks of its member states. The 19 Members of the ESM on the other hand, have granted it an overall capital of €700 billion, more than €80 billion of which has been paid in. It is the highest paid-in capital of all international financial institutions in the world. But the ESM does not use this money to finance rescue loans. This capital functions as a security buffer, to give the ESM an excellent credit rating and to inspire investor confidence. And this works, because the ESM’s rating and its reputation allow it to issue bonds and bills in the market at very low rates to raise the money to finance the rescue loans for the five programme countries.

To be clear, this means, that not a single euro of German or European tax money flows to the rescue loans for Greece and the other four programme countries. And like I said, the ESM grants loans which programme countries in the end need to pay back in full. There is not a single line in the German federal budget or in the budget of any other euro country to account for the costs of our programmes. And so there are no transfers, and there is no bail-out.

On the other hand, it is true that the ESM member countries take on risk through the ESM loans. And that is why it is good that the German finance minister needs a mandate from the German lower house for an ESM programme or the disbursement of a new tranche. This assumption of risk is an act of solidarity amongst euro states and cannot be valued highly enough. But it does not turn the economic and monetary union into a transfer union! Many other guarantees of the federal budget, such as export guarantees, do not cause any spending either as a rule.

Despite this, the accusation that we break the rules is levelled at us time and time again, especially in Germany. And that while both the German Federal Consitutional Court and the European Court of Justice have confirmed the legality of the EFSF and ESM rescue mechanisms on multiple occasions at the highest legal level. Since 2011, the Federal Constitutional Court has issued five injunctions that relate to us. In these rulings, the Federal Constitutional Court has strengthened the role of the German lower house and its members and has explicitly said that setting up the EFSF and the ESM and the duties that flow from it are in line with the law.

An appendix to the EU Treaty, which has been adopted by all EU member states, makes clear that financial help to stabilise the euro area is allowed. Admittedly, the Federal Constitutional Court in its ruling of 18 March 2014 says that this is “a fundamental transformation of the original Economic and Monetary Union, because it has now departed from the principle of the autonomy of the national budgets that had so far characterised it, even if only to a small degree”. But it also maintains that this appendix does not mean that Europe has abandoned the “stability-oriented principles of the Economic and Monetary Union,” which continue to be the basis and necessary condition for Germany’s participation in the currency union.

Moreover, the EFSF and ESM did not set a mechanism in motion that would lead to “a transfer of liability for decisions taken by other countries”, according to the ruling of the Federal Constitutional Court. And finally: the European Court of Justice in its ruling of 27 November 2012 clearly notes that the granting of financial assistance by the ESM does not violate the no bail-out clause. The reason is that programme countries remain responsible for their liabilities with creditors. This means that the liability principle, which rightly was so important for Walter Eucken, remains secure in the monetary union even after the establishment of the ESM. Given these rulings by the highest court in Germany and the European Court of Justice, I really have a problem with the continuous reckless talk by some people in Germany about breaking the rules.

Why setting up the euro and the ESM was in the interest of all countries – particularly Germany’s

Germans also love to discuss whether the euro is good for Europe and for Germany.

At the same time, some 80 percent of the German population support the monetary union and for me as an economist the advantages of the monetary union are obvious. The euro boosted cross-border trade among euro area countries, and transactions costs have clearly fallen, by an estimated 20 to 25 billion euros per year. That means price transparency has risen, which in turn led to more competition. Economists know that more competition leads to higher productivity, and therefore to more growth. Hardly any country could benefit more from the euro than Germany, because of its central position in the heart of Europe and its export-oriented economy.

What is often forgotten, is that the introduction of the euro put an end to currency turmoil between European countries. But such turmoil occurred quite frequently in the period between the end of the Bretton-Woods System in the early 1970s until the introduction of the euro. In 1991 and 1992 for instance, the Bundesbank executed interventions of around 100 billion Deutschmark to keep the French franc inside the European currency system. In 1995, the so-called Tequila crisis – problems in Mexico in other words – led to a massive appreciation of the Deutschmark in comparison to other European currencies. German exports clearly suffered. The appreciation cost the German economy one percentage point of growth at the time. But somehow people seem to think that there was never a crisis in the decades before the euro.

Try to imagine the economic turmoil – and probably political turmoil too – that the individual countries of the euro area would have gone through if we had not had the euro during the many crises of the last 20 years, but would have instead had the Deutschmark, the franc, the lira, the peseta, the schilling, the escudo and a dozen other currencies. Because crises there were plenty: the Asia crisis, the Russia crisis, the bursting of the dotcom bubble, the global financial crisis and the Lehman bankruptcy. Without the euro, all these events would very probably have led to large currency fluctuations in Europe, just as we saw in the 1980s and 1990s. That would not have been good for the German economy.

The euro has given Europe the relevance and clout on the global stage that its individual members simply would no longer have. The euro is the second-most important reserve currency of the world. Europe is a strong actor and can see eye-to-eye with other large currency and economic regions: the U.S.A, Japan, and China. Let’s not forget that Europe’s economic relevance is steadily decreasing. In 1970, Europe made up 32% of the global economy. Nowadays, the number stands at 23% and it is estimated that it will drop to 9% by 2050. Individual member states would hardly count any more, even big European economies like Germany.

In conclusion, the common currency is an achievement worth defending for all euro area countries. At the beginning of 2010, the members of the monetary union were facing a situation the founders of the euro could not have imagined: a loss of market access by euro area countries. This brought to light a gap in the institutional architecture of the euro area. There was no instrument, no mechanism and no institution that could help in such a case and offer a sustainable remedy.
Given this situation, first the EFSF was established in 2010 as a temporary solution and then the ESM as a permanent institution. Both are mandated to provide rescue loans in return for economic reforms in case of a temporary loss of market access. I do not believe that there were credible alternatives to this decision. Had these rescue mechanisms not been set up at the height of the crisis, the consequences for the monetary union would have been dramatic. Countries such as Greece, Ireland, and Portugal would probably have left in chaos, and the resulting social and political consequences would have been hard to predict. It could also have been dangerous for other economies because of probable contagion effects. And the euro itself would have been in danger. It is therefore a good thing that we prevented a break-up of the monetary union. Economically and politically, Europe would look very differently if we had failed to do so.

How to make the monetary union more robust with tangible and limited steps

Finally I would like to talk about what needs to be done to make monetary union more robust with a number of targeted steps. I say “more” robust, because an enormous amount of work has already been done since 2010.
Europe has come out of the crisis stronger than before, both economically and institutionally. There are many reasons for that. First, the five countries that received assistance from the EFSF and the ESM did their homework. Budget deficits have clearly decreased everywhere. Competition has been restored through lowering nominal wages and salaries – what we call internal devaluations – and through structural reforms, particularly in programme countries. Furthermore, coordination of economic policy at the European level has been strengthened and deepened. There have also been important institutional innovations in the past

years. As a lender of last resort for euro area countries, the ESM fills an institutional gap, as this function did not exist before the crisis. A further institutional innovation is Banking Union, which has led to the creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). In short: Europe overcame the crisis by developing an efficient strategy.

The economic recovery that started in 2015, which has become stronger recently, confirms this. Euro area growth is expected to come in above that in the U.S. in 2016 and 2017. Of course we should not forget that we still have some problems, such as high unemployment in some euro area countries, particularly among young people.

What else should we do to make the monetary union even more resilient? There are a number of obvious points.

In the first place, the countries of the euro area should decidedly abide by the rules that they have already agreed. These rules need to be simplified, in particular the monitoring of budgetary policies. Over time, the rules have become so complex, that even experts like myself sometimes struggle to understand them. This weakens the credibility and legitimacy of the rules.

In the second place, countries should continue to implement structural reforms to increase potential growth, by implementing the recommendations of the European Commission more consistently. That is true for all members of the monetary union, not just for ESM programme countries.

The additional steps that are needed to complete the monetary union, are modest in comparison to the measures we have already taken. To be very clear: we do not need a full fiscal union with additional transfers, nor a full political union, for the proper functioning of monetary union. I am also a proponent of a strict adherence to the subsidiarity principle, which was also very important for Walter Eucken. If certain things can be done better at the national or local level, we should leave them there, closer to the people, and not transfer them to the European level – in the monetary union, nor in the European Union.

But certain further steps could be useful. In the first place, we should complete Banking Union. This would strengthen financial integration in the monetary union and risk sharing through financial markets. What is lacking from Banking Union is a common backstop for the single resolution fund, the SRF. Creating such a backstop would strengthen the credibility of the SRF.

The other important step to completing Banking Union would be a form of European deposit insurance. This would first require clearing out the problems with legacy assets that still exist with some banks in the euro area. Such risks must be reduced, because no country with a healthy banking system should pay for the past mistakes of banks and supervisors in other euro area countries. And this means it will take a while before a European deposit insurance will see the light of day. But the advantages of such a credible common deposit insurance are considerable, as it would take away the risk of a bank run on the entire banking system in a country. If a country is under pressure from the market, depositors would know that it is not just their own country backing their deposits, but the entire euro area. And this means that the reason for a country-wide bank run, which would certainly pose a risk for financial stability across borders, disappears. Creating a European deposit insurance that is credible is the best guarantee it won’t be needed.

Capital Markets Union would further strengthen financial integration and make the euro area more robust. Harmonising corporate, tax, and bankruptcy law across Europe would lower the hurdles that are standing in the way of cross-border investments. This would ease cross-border shareholdings and reduce European companies’ overreliance on bank loans to finance investments.

A limited fiscal capacity to counter so-called asymmetrical shocks would be a further step towards a more resilient monetary union. I know the fear that this would lead to debt mutualisation and permanent budget transfers. But examples from the U.S.A. show that a limited fiscal capacity is possible without debt mutualisation and permanent budget transfers. Examples there are rainy day funds and a complementary unemployment insurance. In both cases, American states have access to time-limited surplus funding in times of distress, which they need to repay later.

What we don’t need

What we don’t need in the euro area is a large investment budget. Such an instrument already exists for the EU in the form of the so-called Juncker Plan and the general funding that is available through the European Investment Bank. If needed, such means can be increased. In my opinion, we also do not need more permanent transfers to promote real convergence in the EU. The EU budget rightly has been financing transfers from rich to poor EU countries for the past 60 years. These can amount to 3 percent of the GDP of the receiving countries, which is a substantial number.

We also do not need a large additional budget to counter deep symmetric crises. We have shown that in truly exceptional cases, we can successfully fight a deep crisis through a targeted increase in budget expenditures, such as during the global financial crisis of 2008/09. An exception clause in the Stability and Growth Pact allows breaching the three percent deficit maximum in case of a severe crisis.

The limited fiscal capacity to fight asymmetric shocks that I just introduced would play an important economic role, because monetary policy cannot take on these tasks. In a monetary union, monetary policy cannot even out the different cyclical developments between its member countries. On the contrary: monetary policy as a rule has a pro-cyclical effect: real interest rates tend to be too low in countries with a high growth rate, and probably too low in countries with lower growth. A limited fiscal capacity could therefore play a useful stabilising role in a monetary union.

Finally, let me say a few words about a European Monetary Fund. The discussion paper that the European Commission launched four weeks ago talks about it, and many politicians, central bankers and academics have also mentioned it. I would first like to stress that it is important for me that the IMF stays on board now that we are solving the last remaining problem of the euro crisis: Greece. But a consensus is growing inside Europe that the IMF will not play the same role as it has done if a next crisis breaks out in the euro area. The ESM could in that case play a larger role. Indeed, the ESM has clearly developed since it was set up. Nowadays, it no longer just finances rescue loans. It also participates in monitoring missions in programme countries, it analyses debt sustainability, and it ensures the ability of former programme countries to pay back their ESM loans through its Early Warning System.

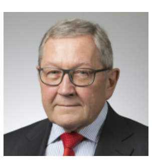
The debate about a European Monetary Fund is at the moment very wide-ranging and contains proposals that are sometimes mutually exclusive. Some would like to put an EMF in control of monitoring fiscal policy, a task that is currently with the European Commission. Others have mentioned a euro area Treasury function, or an institute managing an investment budget for the monetary union. So you can see that many discussions will be needed between the members of the ESM before we can reach a final conclusion.

It is easily imaginable that the ESM will develop into an institution that looks even more like the IMF than is the case presently. But it is equally certain that this would require a change of the ESM Treaty at least – if not EU Treaty – which requires consensus among all our Member States.

Conclusion

Dear professor Feld, ladies and gentlemen. I won't presume I have converted all of you into ardent supporters of the euro rescue policy through my Walter Eucken lecture. But I do hope that my arguments have shown that the further building up of the euro area during the crisis wasn't just in Europe's interest, but also in the interest of Germany. I also hope that you will agree with me when I say that Walter Eucken and his "Ordnungspolitik" have more influence over the monetary union than many – and possibly some among this audience – were thinking. I now look forward to your reaction to my remarks and to engaging in a discussion with you.

Author



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