# Klaus Regling at College of Europe

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**Deepening EMU: Ambition and Realism**
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(*Please check against delivery*)

Ladies and gentlemen,

The construction of the European Union has now been going on for seven decades. During this period, there were moments of soaring ambition. And there were moments of sober realism.

The College of Europe stems from a period of hope. It is itself an institution of hope, established just after Europe took a historic first step towards unification at the Congress of Europe in 1948.

My institution – the European Stability Mechanism – was born at a time that Europe needed pragmatism. It was at the height of the euro crisis. The ESM – and its predecessor, the EFSF - had to be put in place rapidly, to defend the monetary union.

This shows that good things happen in Europe during periods of ambition, as well as during periods of realism. The result is steady progress. Steady progress during the seven decades it took to build the house that we now call the European Union.

At the moment, the mood is very ambitious again. Eurosceptics have lost ground in elections throughout Europe. Emmanuel Macron is France's new and energetically pro-European president. In Germany, I expect Chancellor Merkel's pro-European policies to continue under a new government. This will provide more fuel for the German-French twin engine that has driven European integration forward so often since the war.

Today, Europe again harbours an ambition for further integration. At the same time, the continent is realistic about what it wants to achieve. We are not on our way to become the United States of Europe – with a full political union and a full fiscal union. Therefore, now is a time to realistic, without losing ambition.

Some of our biggest challenges can only be tackled at the European level: migration, terrorism, climate change. Strengthening the Economic and Monetary Union is also one of those challenges, and this is the issue I will talk about.

A list of euro area reforms is now under discussion that is concrete and achievable. Euro area countries expect to reach agreement about it in June next year. But it does not mean a complete overhaul of the monetary union. We don't need that, because the euro area already made immense progress during the crisis, and took steps that would have been unthinkable only a few years ago.

My remarks will have three parts. First, I would first like to address the comprehensive strategy that the euro area developed in response to the euro crisis from 2010. I will then look at the beneficial impact these integration steps have had on the economy. Thirdly, I will speak about the further reforms that are still needed in the monetary union to make it more robust.

The ESM, the institution that I manage, is part of the euro area's comprehensive strategy to fight the crisis. But it is not the only reason why we came out of the crisis. A number of other steps were also instrumental in defending the integrity of the monetary union.

The most important was that countries did their homework. Macroeconomic imbalances, which were a main cause for the euro crisis, have now been sharply reduced.

Competitiveness has returned in most euro area countries, as nominal unit labour costs have converged to more sustainable levels. Former programme countries in particular have made good progress, often after years of excessive wage increases. As a result, the unsustainably high current account deficits from before the crisis have disappeared.

The overall fiscal picture is also favourable because of these national efforts. Public deficits have shrunk after the crisis, and converged to a narrow range. High debt levels in former programme countries are helped further by the ESM’s favourable lending terms. At the aggregate level, debt is decreasing. The euro area debt-to-GDP ratio stood at 91 percent last year, and is projected to continue to drop in the coming years. It is now much better than that of the UK, the U.S., or Japan. Importantly, this gives the region more fiscal policy space than other large economies, if the next crisis hits.

At the European level, the EU fiscal rules were tightened, and the Commission now has new powers to monitor and sanction budget offenders. Economic surveillance was broadened with the new so-called Macroeconomic Imbalances Procedure.

The European Central Bank equally played a crucial role in fighting the euro crisis, through its unorthodox policy measures, in line with other central banks in the world. This is best remembered through Mario Draghi’s “whatever it takes” speech of July 2012.

Next, Europe made important progress through the Banking Union. With the Single Supervisory Mechanism, there is now a central supervisor for the 130 largest banks, while the Single Resolution Board is a cross-border authority to resolve banks. These two bodies constitute a significant transfer of national competences to the European level, and are making Europe’s banks much safer.

Last but not least, let me say a few words about the ESM, my own institution, and another recent addition to the institutional bodies of the monetary union. Its role is to provide financial assistance to euro area countries that lose access to financial markets during a crisis.

We are, in other words, the lender of last resort for sovereigns in the euro area. That function did not exist in the monetary union before the crisis. When the Maastricht Treaty was signed, people thought it was impossible for a country to lose market access once it had entered the monetary union. But this is exactly what happened between 2010 and 2012. As a consequence, there was a real risk that countries such as Greece, Ireland or Portugal could have been forced to leave the euro area. To prevent this from happening, the euro area countries set up a fund for emergency loans at the height of the crisis in 2010. This was the EFSF, a temporary institution, which was followed by the ESM in 2012.

Since 2011, the EFSF and ESM have provided loans to five countries: Greece, Ireland, Portugal, Spain and Cyprus. In total, we have disbursed €273 billion in loans, 2.5 times as much as the IMF globally in the same time period. The ESM has a paid-in capital of €80 billion, the highest of any international financial institution.

The ESM does not spend any taxpayer money to finance its assistance programmes. Instead, we raise money from investors by issuing bonds and bills. We can do this at very favourable rates. This is because of our high credit rating based on the ESM's high paid-in capital. Our low rates mean considerable budget savings for programme countries. The interest payments they make to the ESM are the same as those we pay in the market, and are well below what the countries would be charged in the market. In the case of Greece, this saves the country almost €10 billion per year, or 5.6 percent of its GDP. These are very substantial amounts. And so, euro area countries provide solidarity without spending any public means.

In order to qualify for such advantageous loans, countries must commit to strict economic reform programmes to fix their problems. This means reducing public deficits, and restoring competitiveness by ending unsustainable wage policies and bringing down unit labour costs. Other reforms are aimed at liberalising labour and product markets. And lastly, there are typically also problems in the banking sector that need fixing. The IMF has successfully applied this cash-for-reform approach for decades.

Needless to say, such reforms initially are often painful for the population. Lowering pensions and wages, and cutting government support programmes understandably are never popular. But in the long run, citizens will enjoy stronger economic results. Of the five ESM programme countries, four are success stories now. Ireland, Spain, Portugal and Cyprus have ended their programmes, and their economies are doing well. Ireland's economy grew by 5 percent last year and Spain by 3 percent. This makes them growth champions in the euro area. Programme countries have also done extremely well in modernizing their economies, according the World Bank and the OECD. They are reform champions, and the structural changes they have implemented will form the basis for their future success.

Greece is the only country that is still in an active ESM programme. It is in the final year of the current programme, and the government is on the right track to implement the reforms that it has committed to. If it continues to make these changes, chances are good that it can regularly refinance itself after completing the programme in August next year. Already, Greece made a first step in that direction in July, when it issued its first bond since 2014. Euro area governments have promised to provide further debt relief at the end of the programme, if needed, and if Greece continues to implement the reforms.

In short, Europe came up with a comprehensive policy response to the crisis. As a result, it is now stronger than it was before. Not only institutionally, but also economically. Let me give some evidence of the strengths of the economy in the next part of my remarks.

The economic recovery that started in 2015 has become stronger recently. Confidence among consumers and businesses is at the highest level since the start of the crisis. The recovery is also well-synchronized, with each euro area country growing.

A point that is often forgotten is that Europe's capacity to create wealth for its citizens is as great as that in the U.S. This can be seen from per-capita growth, which is back in line again with that in the U.S. This was the case for decades, but the relationship was disrupted during the crisis. Europe's headline growth rate is often lower, but that is because we have lower population growth and lower birth rates than in America.

Another strong point of the European economy is much better income distribution than in the rest of the world. This can for instance be measured by the GINI coefficient which ranges from 0 to 100, with the lower bound expressing perfect equality. In the U.S., it stands at 41, and in France and Germany around 30. Income equality continued to deteriorate in the U.S – and China – during the last decade but remained broadly stable in Europe. It is true that rising inequality is a problem throughout Western societies, but Europe’s starting position is far better. More broadly, our social model, with a strong safety net for those who need it, is superior in dealing with negative side-effects of globalisation and should help to keep populism in check.

In labour markets, high unemployment remains a problem, particularly in some countries such as Greece and Spain. It is a pressing issue for too many young people. What does not get enough attention to my mind however, is that the employment rate in Europe is higher today than in 2000, which means that a higher share of the population actually has a job than 16 years ago, despite the high unemployment rate. In America, the employment rate has dropped by more than 4 percentage points in that period.

Not everything is well, of course. Europe does need to address its low potential output growth rate. With our poor demographics, growth will mainly come from productivity gains. Structural reforms need to continue in all countries, not just in those who received an ESM assistance programme. Europe needs to further increase the participation rate of women in the labour force, and raise the retirement age. Stronger investment would also help.

In this context, countries should make every effort to integrate immigrants into the work force. Politically, this can be a thorny issue. Yet without immigration, the population of countries such as Germany and Austria would already be shrinking.

Another area where too many weaknesses remain is the financial sector, at least in some countries. It is true that European banks made significant progress, in line with banks in the other main regions of the world. The European banking system is much safer now: equity capital has doubled since 2007. But profitability remains an issue. It has recovered, but is still well below the levels in the U.S.

Non-performing loans have been gradually coming down from a peak in 2013, and are well-provisioned. Still, they are clearly too high, particularly in some countries. Managing non-performing loans eats up capital that could otherwise be used for providing granting loans, and boosting the economy. And it also means that valuable management time is needed to manage these portfolios.

It is clear that reducing non-performing loans is an urgent priority. In that light, it was good to see that EU ministers adopted an action plan to deal with non-performing loans in July. This will help to make banks more efficient, enhance private sector risk sharing, boost economic resilience, and render monetary union more robust.

Economic risk-sharing is an important issue, and one where the euro area needs to do much better. So let me explain this. Risk sharing is the sum of mechanisms through which a shock – positive or negative – to one country's economy is transmitted to others. This helps smooth business cycles. It also makes national economies more resilient and thus the euro area as a whole. In the U.S., but also in countries such as Germany or France, economic risk sharing is much higher than in the euro area. Risk sharing can take place both through fiscal means and through private markets. Both channels need to be widened in the euro area.

One of the reasons for poor economic risk-sharing is the decline in financial integration after the crisis. Or to put it another way, the home bias of banks and market participants remains too high. Financial integration quickly rose after the euro was introduced, as one would expect. But it crashed during the crisis, and still hasn't fully recovered. One of the probable reasons for this is the lack of efficiency in the banking sector, which I just mentioned.

Now let me turn to the final chapter of my remarks: the additional steps that we need to take to make monetary union more robust and the economy more resilient. Broadly speaking, the issues being discussed between euro area countries fall under three headings: financial, fiscal and institutional.
On the financial side, the weaknesses among banks I just mentioned need largely to be addressed by the sector itself. But on the policy side, completing Banking Union is important.

Two steps are under discussion. One is a financial backstop for the Single Resolution Fund. The SRF is slowly building up its war chest. But if it wants to be credible in the eyes of the financial market, it needs to be prepared for any eventuality. Hence the need for a backstop, a role the ESM could take on in the future.

A European Deposit Insurance Scheme is the other step that is needed to complete Banking Union. Depositors will feel much safer if they know the entire euro area is backing their money in the bank, and not just their own government. This will reduce the chances of a sector-wide bank run. Establishing a common European deposit insurance is a complex issue however. It can only happen if the financial health of the banks in all countries is more or less comparable. And at the moment that it is not the case. Therefore, legacy problems such as NPLs need to be reduced first.

The euro area should furthermore harmonize bankruptcy, tax and corporate law, a project known as Capital Markets Union. This would ease the way for cross-border equity investments and open up new ways of funding for companies. Finishing the Banking Union and setting up the Capital Markets Union will be two major steps in promoting risk-sharing in the monetary union.

Changes on the fiscal side are also part of the debate. But let me start by mentioning the things we do not need in this area, in my view. You sometimes hear that the single currency cannot function without a full fiscal union or a full political union. But I disagree. They are neither politically desirable, nor needed for a properly functioning monetary union.

We do not need additional transfers between countries. Transfers are important to promote real convergence, it is true. But the existing EU budget already allows for significant transfers from rich to poor countries, which can amount to up to 4 percent of a receiving country’s economy. The use of budgetary funds to promote real convergence could perhaps be made more effective, but we do not need a completely new instrument. In addition, programme countries that received EFSF or ESM loans benefit from the cheap financing, which is equivalent to a transfer.

We also don’t need a large additional budget to counter deep symmetric crises. Europe has shown that in truly exceptional cases, it can successfully fight a crisis through a simultaneous increase in fiscal deficits. This happened during the global financial crisis of 2008/09. An exception clause in the Stability and Growth Pact allows breaching the 3 percent deficit cap when there is a severe crisis.

Finally, the euro does not need a completely new investment budget. It already exists for the EU, in the form of the so-called Juncker Plan, the EIB, and the structural funds of the EU budget. If needed, these facilities can be increased and their use could become more efficient.

But certain further steps on the fiscal side could help to prevent the next crisis, and to manage any future crisis more effectively. Part of the political debate is about simplifying the European Union fiscal rules. The rules have been made – and I quote – ”more intelligent” in recent years, by adding exemptions and flexibilities. As a result, they are now too complex, and hard to understand. So I welcome the debate on how to make them simpler and more effective.

Further on the fiscal side, the monetary union would benefit from a macroeconomic stabilisation function, or a facility to deal with economic shocks hitting one individual country. An example of such an asymmetric shocks would for example be if Ireland were hit by a hard Brexit. Such a facility will not be an annual budget, but a revolving fund, and there are various ways to establish this. Rainy day funds or a complementary unemployment insurance – which exist in most U.S. states – are options. This is because they do not lead to permanent transfers or debt mutualisation between the participants. Rainy day funds, for instance, pay out during a crisis, but states have to reimburse the money when they recover. A short-term ESM facility with lower conditionality could play a similar role.

Such a fiscal capacity could be combined with a more transparent system for burden-sharing with private creditors in case of a sovereign debt restructuring. Until now, this has happened on an ad-hoc basis, for instance in Greece in 2012, in the so-called Private Sector Involvement. A more transparent system can be set up, including improved Collective Action Clauses (CACs), which would make it easier to reach agreement between creditors in a sovereign debt restructuring. The ESM could take on the role of organising these negotiations, to ensure a fair outcome for all parties involved, along the lines of the so-called London Club.

Now that I have mentioned further reforms on the financial and the fiscal side, let me turn to a number of institutional developments that are also under consideration. A permanent president of the Eurogroup could be useful to better coordinate policies and to represent the euro area in international bodies such as the G7 or the IMF. That person could also become the euro area finance minister, once his or her competences have been clearly defined.

Then, the European Parliament could create a subgroup representing euro area countries. This would facilitate the accountability of anything related to the euro area, which the Parliament now does not have a say in. However, national parliaments will continue to have a say over ESM lending, because the associated risk is assumed by national budgets.

There is also a discussion about developing a European Monetary Fund. So far, the IMF has always contributed to the European rescue programmes, but a consensus is now growing that the IMF will play less of a role in a future crisis. The ESM could take over that role, as well as other tasks. Rather than have a group of four creditors – IMF, ECB, Commission and ESM – the ESM and the Commission would then be responsible together for designing, negotiating and monitoring rescue programmes.

Ladies and gentlemen, let me conclude.

I began my remarks by talking about ambition and realism. Europe has gone through a phase in which there was little time for ambition. Fighting the crisis required an attitude of realism.

Nevertheless, the results of these efforts were substantial. The euro area economy has recovered, and has many strengths, also on the institutional side.

I believe citizens have recognized that. Not only because of the outcome of national elections this year. But also because of the popularity of the euro, which is at record heights. It shows that Europeans believe in the benefits of pragmatic international cooperation. That belief gives politicians a mandate to continue with their reforms of the euro area - to make it more robust and more resilient. And that is why I think that after a period of realism, Europe should today allow itself to be more ambitious.

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