

# "The ESM and euro area financial stability" - speech by Klaus Regling

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Speeches

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**The ESM and euro area financial stability**

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*(Please check against delivery)*

Ladies and gentlemen,

I'm glad to be here with you today for three reasons.

First, because it allows me to explain the work of the European Stability Mechanism. This is necessary because what we do is not always well understood here in Germany.

Secondly, your industry has been undergoing substantial change since the crisis. And so there is a parallel with the ESM, which was born out of the crisis and is also currently in the process of changing.

The third reason is self-serving. The ESM is a heavy bond issuer, and many of you

have invested in us over the years. An investment in the ESM is always an investment in the future of Europe.

Europe's prospects are looking bright. The latest economic data, the political stability of the continent, its prosperity and investor sentiment in this part of the world stand in stark contrast to the uncertainties observed in many other regions.

The crisis in Europe has been over for a while now. The populists ceased to advance last year. The election of President Macron in France on a pro-European platform has spurred optimism. When I meet investors around the world, they tell me that they view Europe as a haven of stability. The upcoming election in Italy will – despite the uncertainty involved – not change the big picture.

Europe is doing well for a number of reasons. Europeans implemented wide-ranging reforms in 2010 in response to the crisis. Institutional innovations that would have been unthinkable only a few years earlier were put into place. If the German coalition agreement works out – which I expect – additional decisions could be taken this upcoming summer, which would further deepen the euro area and thus make it more shock-resistant.

I'd like to discuss three inter-related issues today:

- First, I'll speak about how the currency union was hit by, and subsequently overcame, the crisis
- I'll then go on to explain how this has had a positive influence on the European economy today
- Finally, I'll outline what else we should do in order to make sure that we are well equipped for the next crisis.

Let's look back at the challenges Europe faced over the last few years. In Europe, we experienced not one, but two crises. First, we had to deal with the fallout of the global financial crisis. The collapse of Lehman Brothers also caused great upheaval among European banks. Europe subsequently went through a home-grown crisis, the European sovereign debt crisis.

Ill-devised economic policies had resulted in a loss of competitiveness in some countries, with income increases outpacing productivity gains. Current account deficits grew unsustainably large. Real estate bubbles emerged in some countries. Some states had to take on guarantees for ailing banks, while others had run fiscal

deficits for a long time and were therefore overly indebted. Investors became nervous.

As a consequence, Greece, Ireland and Portugal successively lost market access. Suddenly the break-up of the euro area seemed like a real risk. This situation had not been thought possible by the creators of the currency union.

## **1. How the currency union overcame the crisis**

Europe responded to this existential crisis with a broad policy package. I'd like to emphasize the word 'package' because I believe that the policy measures were only successful in combination with one another. Thanks to their implementation, Europe is now economically and institutionally more robust than many could have imagined in 2010.

The broad policy package involved, first and foremost, the implementation of reforms on a national level, especially in those countries which requested financial assistance: Ireland, Portugal, Greece, Spain and Cyprus. Lacking the option to carry out currency devaluations, competitiveness had to be restored through painful internal devaluations. Salaries and pensions were cut drastically, state spending was reduced, budgets were balanced and politically difficult structural reforms were carried out.

Economic and fiscal policy coordination was also enhanced at a European level. Economic surveillance was widened beyond the fiscal side, in order to get a grip on areas like divergence in competitiveness, real estate bubbles and debt which all had contributed to the crisis. The new Macroeconomic Imbalances Procedure will help the Commission to detect and warn of early signs that a next crisis could be building up.

Further, the ECB played a crucial role in fighting the crisis. Like central banks in the US, Japan or the UK, the ECB followed through with an unconventional monetary policy. I know that these policies are controversial in Germany. Even within the ECB, there are currently debates about the timing and the speed at which we should tighten monetary policy. It is a fact, however, that the ECB played an essential role in keep the euro area together, especially in the early stages of the crisis.

Another important building block of Europe's crisis response is the banking union. With the Single Supervisory Mechanism, there is now a central supervisor for the 130 largest, systemically-relevant banks. The Single Resolution Board is Europe's new cross-border authority which can make sure that banks are resolved in an orderly way.

A last building block of Europe's strategy was the creation of rescue funds, which I head. In 2010, the then 17 euro area countries established the EFSF, a temporary fund. But it soon became evident that a more permanent institution was needed. The now 19 euro area countries therefore created the European Stability Mechanism (ESM) in October 2012.

The EFSF and the ESM fill a gap in the initial institutional architecture of the monetary union. They provide financial assistance to euro area countries that lose market access. We are, in other words, the lender of last resort for sovereigns in the euro area. That function did not exist before the crisis. Because our loans are always conditional on tough economic reforms, we simultaneously resolve the issues that brought about crises in these countries.

Since 2011, the EFSF and the ESM have provided loans to five countries: Greece, Ireland, Portugal, Spain and Cyprus. We have disbursed a total of €273 billion in loans. By comparison, the IMF has only disbursed about €100 billion worldwide.

The ESM does not use taxpayer money to finance its programmes. Instead, we raise money on the capital markets. The rescue funds are some of the biggest bond issuers. The 19 ESM-shareholders, that is, the euro area countries, have made €700 billion available to us, of which €81 billion is paid in. This capital provides security to investors and is the basis of our high credit rating. It is also why we can raise money at low interest rates. Meanwhile, the EFSF is backed by the guarantees of its member states.

The interest payments programme countries make to the ESM are the same as those we pay in the market. They are well below what the countries would be charged by investors. This results in substantial budget savings for the countries in question. For instance in the case of Greece, we estimate that this saves the country almost €10 billion, or 5.6 percent of its GDP. These savings underscore the extent to which the euro area stands in solidarity with the programme countries. But again: this does

not involve spending a single euro of German or European taxpayer money.

These loans are, of course, tied to very strict conditions. What this typically means is that countries must reduce their public deficits, repair the banking sector and implement important structural reforms. Our objective is to restore competitiveness. Today, four out of five programme countries are success stories, with high growth rates and sinking unemployment.

Greece is the sole remaining ESM programme country. Nowhere else were there so many issues and was the public administration so weak. This is also reflected in the fact that the ESM is by far Greece's biggest creditor, having paid out €182 billion in funds. We already have 50 percent of Greek debt on our books. We could have about 60 percent of it by the end of the current programme.

Nevertheless, I'd like to underline the fact that Greece is also making important progress in implementing the reforms that it committed to in 2015, as part of the current ESM programme. The reform efforts of the Greeks – in terms of salary and pension cuts or the reduction of employees in the public sector, for example – are not always appreciated enough in Germany.

If Greece continues to implement the reforms, I am optimistic that the country can become our fifth success story, when the ESM programme ends this August. If the government stays on course, it should be able to regularly refinance itself independently on the market. Greece has already taken steps in this direction. It raised €3 billion by issuing an oversubscribed 7 year bond just three weeks ago.

The euro area countries have promised to continue to stand by Greece's side. The euro finance ministers have raised the prospect of providing further debt relief at the end of the programme, if it is needed. This could involve additional EFSF maturity extensions or the transfer of profits made from central banks' buy up of Greek bonds on the secondary market.

## **2. How the European economy is doing today**

Ladies and gentlemen, let me say a few words on the current state of the European economy. The economy is now expanding at a healthy pace. Growth is almost twice as high as potential growth. All euro area countries are experiencing a broad-based

economic upswing. Growth should remain strong both this and next year. And while the upturn we are currently experiencing is, of course, also cyclical, the foundations of the region's growth are now much stronger.

The high current account deficits from before the crisis have disappeared. The fiscal picture is positive in many countries. Deficits have decreased everywhere. The euro area fiscal deficit was around one percent of GDP last year. Debt is falling.

The euro area debt-to-GDP ratio is projected to continue to drop in the coming years. It is now much lower than in the US or Japan, where it is rising. This gives the region more fiscal breathing space.

Per-capita growth is also back in line with the US. This was the case for decades. However, Europe fell behind during the crisis. At the moment, per-capita growth is actually higher than in the US. Europe's headline growth is often behind the U.S. But that is because we have lower population growth. The differences in headline growth disappear once the differences in population growth are taken into account.

An advantage of the European economy is that income inequality in Europe is lower than in other regions, like the US or China, and increasing less rapidly. In Europe, redistributive taxes and transfers have helped temper rising discrepancies between the rich and the poor. This can for instance be measured by the Gini-coefficient, which is much lower in Europe than in the U.S. Another measure is the rise in income in the top-quintile versus the bottom-quintile. In America, the income of the top-fifth has grown rapidly since 1995. In France and Germany the income of the top quintile has developed similarly to that of the bottom quintile.

Another strong point of the European economy that is often overlooked is the fact that the employment rate in Europe is higher than it was in 2000. A higher share of the population has a job than 18 years ago. In the US, the employment rate has dropped by more than 4 percentage points over the same period.

The euro is enjoying its highest popularity since 2004. The fact that 74 percent of citizens across the euro area support the single currency - with a majority in each country - is testament to the success of the crisis response. But these trends also have to do with the success of our economic and social model - the best model against the negative effects of globalisation. It is also likely that people have seen

that populism elsewhere leads to the kind of uncertainty which they don't want to see at home.

This is not to say that all is well: Europe still has a number of problems to tackle. High unemployment is a worry, particularly among young people in some countries. Youth unemployment is especially worrying because it affects a person's earning potential later in life. Europe's low potential growth rate also warrants attention, and needs to be addressed through structural reforms and investments in education and technology. The participation rate of women in the labour force needs to rise, and Europe needs to 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.

There is also still progress to be made in the banking sector. Despite the strong overall performance of the economy, the sector's profitability is still being undermined by a large number of non-performing loans (NPLs) in some countries. These bad loans stand in the way of new lending banks can take on. The stock of NPLs is gradually declining and they are well-provisioned. But although the capital of European banks has doubled over the last decade, their weaknesses become particularly evident when comparing their performance to that of their U.S. counterparts. In several European countries, there are too many banks and branches and their business models will have to change because of technical progress.

These points show that we need to continue to work on making the monetary union more robust in order to prepare it for the next crisis. I do not currently see that there is cause for concern, but the recurrence of cycles and crises is integral to the nature of our economic system. We should make use of the current economic and political climate to prepare for such a crisis.

### **3. What should be done to deepen the currency union**

I will therefore outline the next steps for deepening the currency union. The euro finance ministers are now working intensely on this issue. At the December summit, European Council President Donald Tusk mandated finance ministers to work on two areas on which there is most consensus: completing the Banking Union and developing the ESM. Fiscal issues are also important, but they remain more controversial. It will therefore take longer to come to a consensus in this regard.

Two further steps are needed to complete the Banking Union. The Single Resolution Fund needs a backstop in order to make it more credible in the eyes of the market. There is a broad consensus that this is a role that the ESM could fulfil.

The euro area finance ministers also agree that Europe needs a common deposit insurance. This would greatly reduce the risk of nation-wide bank runs, when depositors quickly withdraw their money. If bank clients know that Europe's entire banking system is backing their savings, they will feel much safer about their money than if it is just their own government.

I know that this is a controversial issue in Germany. Let me give you a few reasons why I am convinced that a deposit insurance would also be in this country's interest. First, it would reduce the size of any rescue packages in the future. In all of the EFSF and ESM assistance programmes, banking recapitalisation played a large role, because disconcerted depositors withdrew their savings. This weakened many banks.

A complete Banking Union would also ease the cross-border capital flows out of Germany, which are necessary because of its large current account surplus. Finally, I'd like to remind you that Germany's banks themselves relied very heavily on government support during the crisis. In other words: even this country might one day rely on a deposit insurance.

However, before we can put a common European deposit insurance into place, we need to take care of legacy issues in the banking sector. Non-performing loans in various banks in some European countries need to be reduced first. This is why I welcome the non-performing loan reduction plan which the European Union finance ministers adopted last year.

Moreover, the work on the Capital Markets Union needs to proceed in tandem with the completion of Banking Union. This entails harmonising bankruptcy, tax and corporate law, which would lead to greater cross-border investments. We currently don't have one capital market, but 28, or rather 19, because of our different legal systems.

Strengthening the ESM would also help to deepen the currency union and make it more robust. The first of its new functions, which I already mentioned, is that of a backstop for the Single Resolution Fund. More concretely, this could happen in the



form of a credit line for the unlikely scenario that the SRF's own funds - set to total €55 billion in 2023 - are not sufficient. This credit line would have approximately the same volume as the SRF's own capital, between €55 and €60 billion are being discussed. What is important is that this would be a loan, which the SRF would repay the ESM after it has raised money through bank levies.

The ESM could also play a more important role in future assistance programmes. The IMF has become less and less involved in euro area rescue packages. The role of the ESM has increased. The ESM now has its own know-how and the necessary financial power. Since the ESM's programme for Greece, the ESM has not only disbursed cash but has been involved in the drawing up and monitoring of the programmes. This involves debt sustainability analysis, questions of financial stability and market access. In addition, the ESM carries out work in its ex-programme countries as part of its Early Warning System, where we gauge the ability of programme countries to pay back their loans.

Drawing up adjustment programmes - designing, negotiating and monitoring them - could become a joint task of the Commission and the ESM. Clearly, any overlap of responsibilities between the two institutions would have to be avoided and the role of the Commission should be fully respected as laid down in the EU Treaty. The ESM would not play a role in economic policy coordination in Europe or in the implementation of the Stability and Growth Pact, as these are responsibilities of the Commission. It also wouldn't be involved with the Macroeconomic Imbalances Procedure. The ESM would focus on its own strengths, analysing questions of debt sustainability, financial stability and market access.

The ESM could also manage new fiscal facilities, e.g. for macroeconomic stabilisation. Shorter-term ESM loans, to be repaid within a cycle, with a lighter conditionality than our regular programmes, could help stabilize individual euro area countries before a crisis breaks out.

The ESM could also play a role in a potential Sovereign Debt Restructuring Framework. Such a framework would be designed to make settlements with private creditors more transparent. Until now, this has been a rather ad hoc process. The Private Sector Involvement (PSI) in Greece in 2012 is an example. The ESM, which has experience in debt sustainability analysis but also operates close to the market, could play the role of the neutral moderator in the context of such a structure. Further, I am rather sceptical of the notion that we should introduce an automatic

extension of maturities. I fear that the prospect of such an automatic extension would have a pro-cyclical effect and accelerate crises which could have otherwise been avoided. Collective Action Clauses could also be improved as part of such a framework, in order to ease the debt restructuring process.

As a last point on the ESM, let me say that I am fully in favour of integrating it into the EU Treaty. I have been emphasizing this since the ESM's inception in 2012. But changes under secondary law, via Article 352, the legal basis of the Commission proposal, are not the appropriate way to go. I would like to see the ESM introduced into the EU Treaty in the same way as the European Investment Bank (EIB). The EIB is an institution with its own capital and a board in which the shareholders are represented. This solution would require changes to primary law, and therefore changes to the EU and ESM treaties.

Finally, there is a wide range of ideas on the fiscal side. I've already mentioned that there is no consensus on these fiscal issues. They involve an annual budget for public goods, like the protection of our borders and common defence, and a euro area budget. A euro area budget for investments and a revolving fund to tackle asymmetric shocks have also been proposed. Another idea is reforming the fiscal framework, because the rules governing the Stability and Growth Pact have become so complicated that few people understand them. The idea of a euro finance minister has also been floated.

## **Concluding remarks**

Ladies and gentlemen, let me briefly summarize what I've said. The euro area's crisis strategy has worked and Europe has exited the euro crisis in better shape than many expected. This has had a positive influence on the current state of the European economy. We should make use of this situation to decisively work on the next steps to deepen the monetary union. To use an old saying: we should repair the roof while the sun is shining. Finally, let me emphasize that the proposals which are currently on the table seem small in comparison to the efforts which we've undertaken since 2010 to stabilize the euro area. Nevertheless, they would bring us closer to the goal of a more robust monetary union capable of successfully dealing with future crises.

Thank you for your attention.

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