"The future of the ESM" - speech by Klaus Regling

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Ladies and Gentlemen,

I'm happy to be with the Economic Council again. One could almost think that the organizers had political insider information, when they decided to hold the Financial Market meeting 2018 on this day several months ago. The election of the Chancellor today ends an unusually long political transitional period, which followed the parliamentary election in September. It's hard to imagine a better day than today to speak about financial markets and Europe.

The rest of Europe followed the long coalition negotiations with both anticipation and concern. Because Germany is not only considered to be an economic, but also a political anchor of stability. I am certain that the country will now play both roles again.

Important tasks lie ahead of us in Europe. Last December, the heads of government agreed to concentrate on two topics concerning the deepening of the monetary union in the period until their summit in June: completing the banking union and strengthening the ESM.

The organizers have asked me to speak about the future of the ESM and how the ESM promotes stability, growth and investment in Europe. First, I'd like to sketch out how we overcame the past crises and what role the ESM plays in strengthening the monetary union. I'll then explain how the monetary union could be made even more robust.

Over the past decade, Europe has had to master two crises at the same time: first we had to overcome the effects of the global financial crisis. Then came a home-grown crisis, the European debt crisis.

Ill-advised economic policies, with wages and salaries rising much faster than productivity, had led to a significant loss of competitiveness in some countries. As a result, current account deficits became unsustainably large. There were also real estate bubbles in some countries. Some countries had to provide guarantees to struggling banks, others had already had too high budget deficits for a long time and therefore high levels of debt. Investors became nervous.

As a consequence, first Greece and then Ireland and Portugal lost market access. Suddenly the break-up of the euro area was a real risk.

Europe responded to this existential challenge with a comprehensive package of measures. I'm emphasizing the word 'package', because I am convinced that the measures were so successful only because of their combination. This package consisted of five parts.

First, reforms at the national level, especially in those countries, which had to ask for loans from the rescue funds: Ireland, Portugal, Greece, Spain and Cyprus. Salaries and pensions were cut drastically, state spending was reduced, budgets were balanced, pension systems were reformed, politically difficult structural reforms were carried out, competitiveness was regained.

Second, economic and budgetary coordination at the European level was intensified and broadened.

Third, the ECB played a crucial role in combating the crisis with its unconventional monetary policy.

Fourth, the banking union is a crucial building block of Europe’s strategy against the crisis, with the Single Supervisory Mechanism (SSM) for the 130 biggest system relevant banks and the Single Resolution Board (SRB) for the orderly resolution of such systemic banks.

The fifth and final point in the overall strategy against the crisis was the development of the two rescue funds, which I manage. In 2010 the then 17 euro area states founded the European Financial Stability Facility, EFSF, as a temporary rescue fund. In October 2010 the now 19 euro are states founded the European Stability Mechanism or ESM.

The EFSF and ESM fill a gap in the initial institutional architecture of the currency union. They provide euro area countries that lose market access, with emergency loans. We are thus the lender of last resort for states in the euro area. This function did not exist when the monetary union was set up. As our emergency loans are always combined with tough economic reforms, the causes that plunged these countries into crisis are simultaneously addressed.

Since 2011, the EFSF and the ESM have provided loans to five countries: Greece, Ireland, Portugal, Spain and Cyprus. We have paid out a total of €273 billion in loans.

The ESM does not use taxpayer money for its loans. Rather, we raise money on the capital markets. The rescue funds are among the largest bond issuers in the euro market. The 19 ESM shareholders, the euro countries, have provided the ESM with capital totalling €700 billion, of which €81 billion are paid-in. This capital serves as security for our investors and is the reason for our good credit ratings from the rating agencies. For this reason we can also raise money at low interest rates. The EFSF is also covered by member state guarantees.

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. That’s the equivalent of 5.6 percent of its GDP.

These loans are, of course, tied to very strict conditions. What this means is that countries must reduce their public deficits, repair the banking sector and implement meaningful structural reforms. The objective is to restore competitiveness and sustainability to their economies. Today, four out of five programme countries are clear success stories, with the highest growth rates in Europe and rapidly sinking unemployment.

Greece is the sole remaining ESM programme country. Nowhere else was the extent of the problems so large and the public administration so weak. This is also reflected in the fact that the ESM has had to pay out €182 billion in funds and is therefore Greece’s biggest creditor by far.

Nevertheless, I’d like to underline the fact that Greece is also making good progress in implementing the reforms that it committed to in 2015 as part of its 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 programme ends this August. If the government stays on course, it should be able to regularly refinance itself independently on the market.

The euro area countries have promised to continue to stand by Greece’s side, if this is necessary and the country remains on the course of reform. The euro finance ministers have raised the prospect of considering further debt relief at the end of a successful completion of the programme. This could involve additional EFSF maturity extensions or the transfer of profits made from the purchasing of Greek bonds on the secondary market by the cenbtral bank. An additional haircut will certainly not be necessary.

Ladies and gentlemen, the creation of the rescue funds, along with the other elements of the strategy against the crisis, contributed to the fact that the monetary union is working better today than it did before the crisis, and that Europe is doing well again. Trust was created, which encouraged investment. The economy is currently expanding at a rapid 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. In addition we see the disappearance of current account deficits and the healthier state of public finances.

Nevertheless, we continue to face challenges in Europe. Just to mention a few key points: high unemployment in some countries, especially among young people, low potential growth, the integration of migrants. We also need to make progress in the banking sector. Another few key points in this regard are: the high number of banks or bank branches in some countries, the lack of sustainable business models, the still high proportion of non-performing loans in some banks and banking systems.

There will always be crises now and again in our economic system. I therefore recommend making the monetary union more robust, in order to be prepared when the next crisis comes.

Since the end of last year, the euro finance ministers have been working to deepen the monetary union, in particular by completing the banking union and the further development of the ESM.

Two further steps are needed to complete the Banking Union. The Single Resolution Fund needs a backstop to make sure that it has sufficient cash available, even in major crises. There is a broad consensus that the ESM should assume this role. I will come back to this topic in a moment.

The euro finance ministers are also in agreement that monetary union and the banking union need a common deposit insurance. This would virtually eliminate the risk of a bank run, when savers panic and withdraw their deposits. If bank customers know that not only their government, but the entire European banking system protects their savings, they will feel much safer.

I know that many of you are sceptical. But a deposit insurance is also in the German interest. There are several reasons for this: for example, the size of rescue packages would have been much smaller in the last eight years if a deposit insurance had already been in place. In all EFSF and ESM programmes, the recapitalization of banks has taken up a significant portion of the loan sums, as worried savers withdrew their money during the crisis. Had there been a credible deposit insurance, it would not have come to such withdrawals. A common deposit insurance would also help reduce the current fragmentation of the European financial and capital markets. This could allow the ECB to steer towards higher interest rates and would also reduce the TARGET imbalances.

Before we can put a common European deposit insurance in place, we need to take care of legacy issues in some banks. Above all, non-performing loans in banks in some European countries need to be reduced. National deposit guarantee schemes need to be more closely aligned and the volume of government bonds in bank balance sheets should be reduced.

In addition, the capital markets union should be implemented in parallel to the completion of the banking union. This requires some harmonization of insolvency, tax and corporate law in the member states and would facilitate cross-border equity investments.

Strengthening the ESM would also help make monetary union even more robust and crisis-proof. The first of the new tasks of the ESM would be to provide a backstop for the Single Resolution Fund (SRF), which I've already mentioned.
The ESM could also play a more important role in future rescue programmes. The role of the IMF in the programmes has become significantly smaller since 2010. At the same time, the role of the ESM has increased. Today, the ESM has its own know-how and the necessary financial firepower. Since the ESM programme for Greece, the ESM has not only paid out money, but has increasingly been involved in the preparation and review of the programme.

The development of adjustment programmes – their design, negotiation and monitoring – could become a joint task of the Commission and the ESM. It is clear that the competences assigned to the Commission in the EU Treaty must be respected. The ESM would do complementary work, focusing on its own strengths and, for example, analyse issues related to debt sustainability, financial stability and market access.

The ESM could also manage new facilities, e.g. for macroeconomic stabilisation. This could take the form of short-term ESM loans, which would have to be repaid within a business cycle, and which would have lighter conditionality than our regular programmes.

I know that there is great scepticism in Germany. But I think that such a financial facility would be in the German interest. For it is better to stabilize individual euro area countries via a smaller short-term emergency loan, than to wait until a system-threatening crisis breaks out and a full adjustment programme with larger loans is needed.

The ESM could also play a role in debt restructuring. The aim would be to create a predictable framework for debt restructuring negotiations with private creditors. The ESM, which has experience in debt sustainability and is also very active in the market, could take on the role of a neutral moderator within the context of such a predictable framework.

However, I find it important to emphasize the word ‘negotiation’. I am sceptical about the proposal to automatically extend maturities. I’m afraid that the prospect of automatic maturity extensions would have a pro-cyclical effect and accelerate a crisis, which could have otherwise perhaps been avoided.

As a last point on the ESM, let me say that I am fully in favour of integrating it into the EU Treaty. I would advocate that the ESM be 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 treaty and, of course, the ESM treaty. The final decision would remain with the member states and the participation rights of the Bundestag and other parliaments would be respected.

Finally, there is a wide range of ideas on the fiscal side. However, so far there is no consensus in this area. They involve an annual budget for European public goods, like the protection of our borders and common defense, and a euro area budget. A euro area budget for investments or a revolving fund to provide loans to individual countries in order to tackle asymmetric shocks have also been proposed. Another idea is simplifying the rules on fiscal surveillance, because the rules governing the Stability and Growth Pact have become so complicated that few people understand them.

Ladies and gentlemen, let me summarize. Europe’s strategy against the crisis has worked. Europe has exited the euro crisis in better shape than many expected. The successful work of the ESM promotes stability, growth and investment in Europe. It has had a positive effect on current economic conditions. We should use this situation to further deepen the monetary union and make it even more robust against future crises. Compared to what we built during the last crisis years, the work that remains is relatively modest.

I thank you for your attention.

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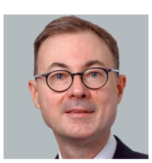

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