“Completing the Monetary Union: The role of the ESM” - speech by Rolf Strauch

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Rolf Strauch, ESM Chief Economist
“Completing the Monetary Union: The role of the ESM”
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Ladies and Gentlemen,

I am pleased to be here at this conference today, organised by the Bretton Woods Committee and its partners.

The rise and fall of the Bretton Woods system illustrated how the institutional arrangements, which underpin economic activity, tend to change over time. In the euro area, we are once more confronted with the need for institutional change.

Our panel focuses on the euro and the European Central Bank (ECB). This gives me the opportunity to give you my take on how a strengthened European Stability

Mechanism (ESM) could help make the euro area more robust.

The current favourable economic situation in the euro area provides a rare opportunity to strengthen the monetary union. Last year, the euro area grew by 2.4%, which is the highest growth rate since 2007. Growth was broad-based, reaching all euro area countries. Euro area GDP-per-capita growth outpaced the US during the last two years. Unemployment has decreased to its lowest level in almost ten years while labour force participation rates are at an all-time high. Moreover, support for the euro is at its highest level since 2004, with three out of every four citizens in the euro area supporting the single currency.

In addition, there has been remarkable progress in the last ten years in making the euro area more resistant to shocks. Due to structural reforms at national level and closer economic coordination, macroeconomic imbalances within the euro area have been significantly reduced. The European Central Bank’s (ECB) unconventional monetary policy as well as the introduction of the first two pillars of the Banking Union, the Single Supervisory Mechanism (SSM) and the Single Resolution Board (SRB), also helped to combat the crisis and made banks much stronger. Finally, establishing the temporary European Financial Stability Facility (EFSF) and the permanent European Stability Mechanism (ESM) helped to ensure financial stability in the euro area.

The euro area is currently benefitting from a favourable economic environment, but the good times will not last forever. We need to fill the remaining institutional gaps and ask ourselves “what about rainy days in the future?” Because there will inevitably be a slowdown as the economic cycle comes closer to its peak and growth starts decelerating to potential growth. That is why our efforts should be directed at deepening monetary union.

The euro area economy is facing is a lack of risk sharing, which is making it harder to deal with difficult times. Risk sharing is underdeveloped in the euro area, when compared with the United States, but also when compared with large countries inside the euro area such as Germany or France. First and foremost, risk-sharing can take place through income flows and market interactions in the private sector – mainly banks and financial markets. Then it can also take place through fiscal tools. The more risk countries share through the private channel, the less need there is for fiscal support.

The lack of risk-sharing through the private channel can be understood because we have not yet created fully integrated European banking and capital markets. But we can strengthen banks by completing the Banking Union and setting up the capital market union.

Completing the pillars of the Banking Union would mean to set up a common backstop for the Single Resolution Fund (SRF) in the shorter term, and the gradual introduction of the European Deposit Insurance Scheme (EDIS) over the longer-run. EDIS will create a level playing field for banks and savers within the Banking Union. It is efficient because it virtually eliminates the risk of nationwide bank runs, which cause high costs during crisis periods.

But before we put a common European deposit insurance in place, risks in the banking system need to be reduced. In particular, non-performing loans (NPLs) in some European countries need to be dealt with; national deposit guarantee schemes should be harmonised and filled. In the long run, we also need to consider whether banks should decrease the volume of domestic government bonds in their balance sheets. Moreover, insolvency laws could be harmonised further.

The capital markets union should be implemented in parallel to the completion of the Banking Union. This requires harmonisation of insolvency laws, tax and corporate laws in the euro rea countries and stronger support for cross-border equity financing also across borders.

Let me now turn to my own institution and outline the future role of the ESM. The ESM has developed since its inception. The EFSF, the ESM's predecessor, was set up as a temporary solution in 2010. Its initial function was that of a cash machine, i.e. to raise money, and disburse loans to programme countries. Today, eight years later, the ESM – a permanent institution – has built up a track record of achievements. Four of the five countries that received EFSF or ESM loans have successfully ended their programmes, and are among the best performers in terms of growth rates in the euro area. Our task of financing the programmes has given us considerable expertise operating in financial markets, and analysing them. In 2017, EFSF and ESM together issued €61 billion in bonds. The complex and highly technical work on the short-term debt relief measures for Greece, implemented last year, is yet another example of our market activities. Over the years, we have taken on additional tasks. The ESM is now more closely involved in the design of the programmes. We monitor whether former programme countries can pay back their loans with our so-called Early Warning System. And the debt sustainability analysis we have provided for programme countries is state-of-the-art.

The fact that the ESM has matured, and its successful track record have led policy-makers to consider an extended mandate of the ESM, to help deepen EMU. Here different elements are discussed.

Firstly, as mentioned before, the ESM could provide a backstop for the SRF. Bringing the SRF to its full financial firepower is a process that will last until 2023. A financial backstop would have a clear signalling effect for financial markets, reflecting that the SRF is prepared for any crisis eventuality. There is broad support among euro area Member States for the ESM to become the backstop of the SRF.

Secondly, the European Commission and the ESM could jointly prepare, negotiate and monitor the macroeconomic adjustment programmes in euro area countries. Needless to say that this would happen without overlap of duties and in full respect of the mutual competences of both institutions. In other words, the competences assigned to the Commission in terms of budgetary surveillance must be respected. The ESM would focus on its own strengths which are related to its mandate: market access, debt sustainability and financial stability.

The ESM could also administer a new fiscal stabilization facility for the euro area, if Europe were to set this up. At the moment, there is not much political consensus to create more fiscal capacity at a European level. Many ideas exist, for instance a European Union budget for common public goods such as defence, or the security of external borders, or fighting climate change. A budget for investments and a revolving fund to tackle asymmetric shocks have also been proposed. The latter could for instance take the form of a rainy day fund that enables countries to save in good times, and consume their savings in an economic downturn.

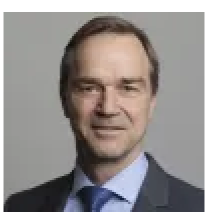
Such a macroeconomic stabilisation function could also work in the form of short-term ESM loans, which would have demanding eligibility criteria, but less stringent ex-post conditionality than regular ESM programmes. Countries would have to repay the loan within a business cycle, thus excluding permanent transfers. The rationale is that it is better to stabilise individual countries in a monetary union well in advance, rather than to wait until a major crisis requires a macroeconomic adjustment programme.

Finally, the ESM could play a role in a framework for sovereign debt restructuring negotiations with private creditors. The ESM has experience and expertise in debt sustainability and is an active market player. Hence, it could take on the role of a neutral moderator in such a framework. The framework would reduce the risk for taxpayers because, on the one hand, private bondholders would share the cost of a sovereign default and, on the other hand, because it would instil market discipline as markets would price in risk premia more appropriately. The framework would not make use of rigid rules like automatic extensions of maturities. These extensions could precipitate a crisis that otherwise would have been avoided. Instead, it would work with a creditor committee along the lines of the London Club, which the ESM could manage.

Let me conclude. Institutional arrangements change over time. The institutions of the euro area have evolved since their inception, though the pace of change has varied. What we have accomplished over the last decades should give us the confidence that we can also tackle the remaining challenges.

Thank you for your attention.

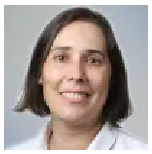
Author



Rolf Strauch
Chief Economist and Management Board Member

Contacts

Cédric Crelo
Head of Communications and Chief Spokesperson
+352 260 962 205
c.crelo@esm.europa.eu



Anabela Reis
Deputy Head of Communications and Deputy Chief Spokesperson
+352 260 962 551
a.reis@esm.europa.eu

Juliana Dahl
Principal Speechwriter and Principal Spokesperson
+352 260 962 654
j.dahl@esm.europa.eu