Europa - quo vadis? The role of the ESM - speech by Klaus Regling

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23/07/2018
Speeches
ESM
Munich, Germany

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„Europa – quo vadis? The Role of the ESM"
Panel discussion of the Economic Advisory Council and the Representation of the European Commission in Munich
Munich, 23 July 2018

Dear Mrs. Wolf,
Dear Mr. Menze,
Dear Prof. Zeitler,
Ladies and gentlemen,

First, a big thank you to the Bavarian Economic Advisory Council and to the Representation of the European Commission in Munich for the invitation. I am pleased to have the opportunity to speak in this context about the deepening of Monetary Union and, in particular, the future of the ESM.

I will explain where we are currently in the euro area from my point of view, how we have overcome the past crisis and how we can make the currency union even more

resilient. In doing so, I will talk about the topics that are most controversial in Germany:

- Greece,
- The completion of the Banking Union, including a European Deposit Guarantee Scheme,
- The usefulness of fiscal capacities,
- The future role of the ESM.

How we overcame the past crisis

The eurozone has experienced strong growth since 2016. Budget deficits have narrowed. And debt is falling. Quite different for example from the US or Japan. That is a remarkable achievement. Just a short time ago, the euro area was in its worst crisis yet. Europe had not only one but two crises to overcome. First, we had to overcome the effects of the 2008 global financial crisis. Subsequently, we had to deal with the euro crisis.

In response to the biggest economic crisis in 80 years, a comprehensive package of measures was developed, consisting of five key elements:

First, the crisis countries have implemented far-reaching reforms, consolidated their public finances, and improved their competitiveness. The trigger of the crisis were wrong economic policies pursued by these countries. Salaries and wages rose much faster than productivity. This led to a loss of competitiveness and huge current account deficits. Budget deficits were also too big. And in the end, these countries lost access to the capital market. This meant that investors were no longer prepared to grant new loans to these countries.

Second, economic and budgetary coordination and monitoring at European level has been improved and broadened. Surveillance was originally based primarily on fiscal rules. That was not wrong, but too narrow. The European Commission now has a mandate to identify other macroeconomic imbalances and to monitor their development. Measures to prevent and correct, for example, high current account deficits or excessive credit growth, are now possible through the Macroeconomic Imbalance Procedure.

Third, the European Central Bank (ECB) stabilised the euro with its unconventional

monetary policy. There is now – especially in Germany – considerable controversy over monetary policy. In my opinion, there should be no doubt that the unconventional monetary policy – with which the ECB has only copied measures used by other major central banks – was also decisive in getting us out of the crisis.

Fourth, Europe's Banking Union was created with the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRB): the Single Supervisory Mechanism oversees systemically important banks, and the Single Resolution Mechanism resolves banks in an emergency and terminates their operations.

And as a fifth element, the euro rescue funds were set up: in 2010, the temporary European Financial Stability Facility (EFSF) and, two years later, the permanent European Stability Mechanism (ESM).

The permanent rescue package: the European Stability Mechanism (ESM)

Before the rescue funds were created, there was no "lender of last resort" for euro countries. For the ECB is, of course, the lender of last resort for the banks in the euro area but not for the governments. That would be "monetary state financing" and is rightly prohibited. Therefore, the two rescue funds have closed an institutional gap in the architecture of the Monetary Union.

The ESM made a significant contribution to overcoming the crisis and to the economic recovery in the crisis countries. Of course, the ESM did not solve the crisis on its own. But without the creation of the two rescue funds, many countries would most likely have been forced to leave the euro area. Europe would look different today!

When the ESM grants loans, it follows the well-established principle of the International Monetary Fund (IMF): loans are only disbursed if the recipient country implements the reforms that it has committed to under its ESM programme. This always includes fiscal consolidation, structural reforms, and the repair of the banking sector. Of course, these reforms are painful for the population and politically difficult for the government. However, they are necessary, for example, to regain the lost competitiveness in Monetary Union and to restore investor confidence.

The rescue funds secures the money for its loans by issuing regular bonds. The programme countries commit to repaying their loans in full with interest. Contrary to what is sometimes said, there is no transfer of taxpayers' money in ESM programmes. However, risks are taken.

With a subscribed capital of around €700 billion and approximately €80 billion in paid-in capital, the ESM has the highest paid-in capital of any international financial institution. The capital of the ESM serves as collateral for investors. This security is why the ESM has an excellent rating and only has to pay very low interest rates in the market. We pass on these favourable conditions to our borrowers. This gives us the opportunity to lend at around 1% of interest, while countries in economic difficulty sometimes have to pay up to 7% or 8% in the market. That is why these countries save a lot of money.

In the case of Greece, we estimate that the ESM loans result in annual budget savings of almost €12 billion. This is 6.7% of Greece's economic activity (GDP) in 2017. And this without incurring any costs for the European taxpayer. The savings are an expression of solidarity among euro countries.

The EFSF and the ESM have granted loans to five countries since 2011: Greece, Ireland, Portugal, Spain and Cyprus. The two institutions disbursed some €280 billion over that period.

Four of the five programme countries are now economic success stories. They are among the most dynamic economies in the EU, with high growth rates and rapidly sinking unemployment. Moreover, these countries can refinance themselves in markets again without any problems.

Greece, the only country still in an ESM programme

Greece is the only country that is still in an ESM programme. There are three reasons why it took Greece so long. First, the problems at the beginning of the crisis in Greece were much deeper than in other programme countries. Second, the country’s administration is weaker than that of other euro area countries. And third, unfortunately, the country reversed very important reforms in the first half of 2015. There was an attempt to halt the reform programme it had agreed to. The result was that Greece dropped back into recession. The Greek central bank estimates that this

cost the country some €86 billion.

Since then, Greece can point to impressive progress. Wages and salaries were cut by 20 to 30%. That was needed, because they had risen much faster than productivity in the past. As a result, the country lost its competitiveness. Since 2016, the Greek budget has consistently posted a small budget surplus, and that while in 2009, it had a budget gap of 15% of GDP. So Greece has something in common with Germany, which also has a small budget surplus.

Greece's current programme will end on 20 August 2018. The ESM will disburse a final €15 billion loan once all national procedures have been completed. This will allow Greece to leave the programme with a liquidity buffer of more than €24 billion in August. This liquidity buffer is sufficient to cover Greece's financing needs for 22 months after the end of the programme.

Moreover, the latest Eurogroup meeting of euro area finance ministers agreed to provide further debt relief measures. The finance ministers had already promised this in May 2016 and again in June 2017, if Greece were to successfully conclude its programme. None of these measures have an impact on the German budget. There will be no haircut.

You may ask if Greece will ever be able to repay the money it has borrowed. My answer to that question is: yes, it will. Economies that have been weakened by a crisis can pay back rescue loans in their entirety, as long as debt servicing costs are spread over time, and do not exceed the threshold of 15 to 20% of GDP.

Germany itself was the beneficiary of debt servicing costs spread out over time. It was only in 2010 that it paid the last instalment of the 1953 London agreement on Germany's debts – 57 years later.

The goal of the assistance programmes and reforms in Greece over the past eight years has been to create a new basis for healthy and sustainable growth. This is in the interest of the Greek people, but also in the interest of the euro area, and the ESM. The ESM is by far Greece's largest creditor. So far, both institutions have lent €189 billion to Greece. That is roughly 100% of Greek GDP, and more than half of its public debt.

For the future, it is important that Greece continues to reform its economy. If it rows back on reforms, some of the additional debt relief measures will be suspended. Athens will remain under the scrutiny of the ESM until all loans have been fully repaid.

Greece knows that financial markets and investors will constantly monitor and assess the country, just like other former programme countries. What is important for the market is that Greek economic policy continues to aim for growth and competitiveness after the end of the programme.

Making the monetary union more robust and resilient

From Greece, let me now turn to the euro area. As you know, there is a discussion about plans to make the monetary union more resilient and more robust. Europe's heads of state and government at their last summit in December and June highlighted two issues: completing banking union and developing the ESM.

Completing banking union means two things. First, the creation of a backstop for the Single Resolution Fund, so that it also has enough money during a very large crisis. And secondly, it implies a common deposit insurance. This is the final building block to complete banking union.

I know that a common deposit insurance for Europe is a very controversial issue in Germany. So let me say a few more words about it and explain why I believe that a Europe-wide deposit insurance is also in the interests of Germany.

A common deposit insurance would help to reduce the fragmentation of financial markets in Europe, and help create common financial markets. But before we can introduce a common deposit insurance, risks need to be reduced. The level of non-performing loans is still too high at some banks. These loans have substantially dropped: by 15% across the euro area in the past year. But this trend must continue. Moreover, the high share of domestic sovereign bonds on the balance sheets of banks in certain countries needs to come down.

The volume of the past ESM programmes would have been much lower had a common deposit insurance already been in place, which shows why it is a useful tool. A large part of the ESM programme financing had to be used to recapitalise

banks in programme countries, as nervous savers pulled their deposits out of banks during the crisis.

A credible Europe-wide deposit insurance would remove savers' fears that the euros they had put into the bank would be converted into a new national currency. And so, the risk of nation-wide bank runs would practically disappear. Depositors would know that the entire European banking system would back their savings, and not just their government. In other words: putting a credible deposit insurance in place is the best guarantee it would never be used.

Another advantage is that common deposit insurance would reduce the fragmentation of financial and capital markets in Europe. Then, the imbalances in TARGET could come down again. Also, a more integrated financial market would improve the monetary transmission mechanism, and make euro area monetary policy more efficient. Under such circumstances, the ECB could probably aim for higher interest rates. All that would be in Germany's interest.

The future role of the ESM

Now let me say a few words about the role of the ESM. The heads of state and government have agreed to develop a wider mandate for the ESM, to make the monetary union more robust. In the future, the ESM could take on the following new roles.

First, the ESM will take on the role of a backstop for the resolution of banks in the banking union. The ESM could provide a credit line to the SRF that would have roughly the same size as the own funds of the SRF.

Should this credit line ever be used, the SRF would reimburse the amounts via levies from the European banks. The backstop should be fully ready for use by 2024 at the latest. This deadline can be advanced should a sufficient degree of risk reduction be achieved in the banking sector.

Second, the ESM should get a stronger role in future crisis programmes. The ESM could, in close cooperation with the Commission and in liaison with the ECB, design, negotiate, and monitor programmes. In so doing, care must be taken that there is no overlap in the tasks of the ESM and the Commission. The competencies of the

Commission, as they are defined in the EU Treaty, must be respected.

Third, the Eurogroup will review the ESM’s “toolbox”. The ESM has several financial assistance instruments it can use to help euro area countries in a crisis. Up to now, only two of the six instruments have been used: long-term loans with far-reaching conditionality in the context of an ESM programme as in Greece, Ireland, Portugal, and Cyprus. And a loan to the Spanish government to recapitalise the banking sector.

The review of the ESM instruments includes precautionary tools, which the IMF also has. There are also discussions about cancelling certain ESM instruments such the instrument of direct bank recapitalisation. Instead, it might make sense to create short-term ESM loans with the aim of macro-economic stabilisation, especially in the event of asymmetric shocks. The idea would be to offer help in a smaller crisis and thereby prevent it from turning into a big crisis. But the topic generates controversy, especially in Germany; and there is no consensus in the Eurogroup.

As an economist, I would like you to consider the following: Membership in a currency union means losing two macroeconomic steering instruments: monetary policy and exchange rate policy. The only remaining instrument is fiscal policy.

We also know that monetary policy in a big currency union always has pro-cyclical effects. Regions or countries with higher economic growth and as a result higher inflation rates tend to have lower real interest rates. Regions and countries with lower economic growth tend to have real interest rates that are too high. We can observe this in Europe just as in the US or in China. And when monetary policy has pro-cyclical effects, there is good reason to strengthen the other macro-economic instrument – fiscal policy.

Of course, all member states of the currency union should first and foremost build their national fiscal buffers, as prescribed by the Stability and Growth Pact. But these national buffers could be extended by European instruments without creating any transfers. Short-term ESM loans would only be one way to do that.

One last point on the future of the ESM: There are proposals to make the participation of private creditors in debt restructuring more transparent and efficient. For, it must be ensured that the ESM only grants financial assistance to

member states with sustainable debt. This has nothing to do with automatic debt restructuring. The ESM can ease this process by providing a debt sustainability analysis and by moderating talks between creditors and debtors.

Let me add a few words on the institutional and legal basis of the ESM. The ESM Treaty is an intergovernmental treaty. That means that the ESM is not an EU institution, legally speaking. The transposition of the ESM into the legal framework of the European Union should happen a later stage when the EU Treaty is one day changed.

When this happens, the position of the European Investment Bank (EIB) could serve as an example. The EIB is anchored in the EU Treaty with its own protocol, own capital, and its own governing bodies in which its shareholders – the EU Member States – are represented. Until such an EU Treaty change takes place, the ESM's legal framework will continue to be intergovernmental.

Germany as part of the currency union

As I speak in Munich today, I want to finish with some words on Germany's role in the currency union.

Germany has always been rather sceptical with regard to the euro rescue strategy. That includes the rescue funds. They have always been accompanied by legal controversy in Germany. It was frequently reported that the euro rescue involved a "breach of law" although the Federal Constitutional Court has ruled several times that the rescue funds were legal.

In the past seven years, the Federal Constitutional Court has issued five rulings on this matter. In so doing, the court has strengthened the participation rights of the German parliament. The German finance minister needs a parliamentary mandate for all important ESM decisions. Since all important decisions are taken unanimously at the ESM, no ESM decision is possible against the wishes of the federal government or the parliament.

Also, the Court of Justice of the European Union has ruled that ESM financial assistance does not constitute a breach of the so called "no bail-out clause". The reason is that all programme countries remain liable for their liabilities towards the

creditors. As a result, the liability principle remains in place after the creation of the ESM.

As already mentioned: Had the rescue funds not been created at the height of the crisis, countries such as Greece, Ireland, and Portugal would probably have exited the currency union. As a result of spillover effects, other economies would also have been endangered and the euro area would look different today. Germany with its central location at the heart of Europe and as an export-oriented economy would have been heavily impacted.

Dear Ladies and Gentleman,

I was recently asked what drives me professionally. My answer was clear: Europe. Even if some areas still need improvement, we have achieved a lot. And the monetary union grew with the challenges.

The ESM has made a remarkable contribution to greater stability, growth, and investment in Europe. This is mirrored by the positive economic situation, not only in individual countries but in the entire euro area.

The very good economic situation should be used to render the currency union even more robust and resilient. It is important that Europe be well prepared when the next crisis comes.

I thank you for your attention and I am looking forward to a lively discussion with you.

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