The future of EMU and the role of the ESM - speech by Klaus Regling

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28/11/2018
Speeches
ESM
Luxembourg, Luxembourg

Klaus Regling, ESM Managing Director
"The future of EMU and the role of the ESM"
EIB/ECB Conference
Luxembourg, 28 November 2018

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Ladies and gentlemen,

There’s never a boring moment in Europe. Monetary policy normalisation, rising populism and protectionism, and profound technology changes pose new challenges, just as we commemorate the start of the global financial crisis a decade ago. At today’s conference, you discussed some of these issues.

Since the crisis, Europe has spent much energy to strengthen the Economic and Monetary Union – economically and institutionally. Governments, central banks, banks, supervisors and market participants all did their part. As a result, the crisis is now well behind us, and the monetary union stronger than 10 years ago. The economic situation is favourable – particularly in the countries that received ESM support.

But has Europe really done enough to prepare for the next crisis? Is the single currency fulfilling its promise of improving living standards? How should we react when the U.S. questions multilateralism? What is Europe’s response when we see the Trump administration using the dollar as a weapon in foreign policy? Shouldn’t Europe become more independent?

The ESM was set up to fight crises in Europe. I believe we’ve done that job rather well. And we want to continue to do it well. That is why we are thinking about the questions I mentioned.

In my remarks, I’d like to address two questions. First, how to make the euro area more resilient against a next crisis? And second, how to strengthen the role of the euro on the global stage?

Europe is working on a series of **political initiatives to deepen the monetary union**. The topics on the agenda are completing the Banking Union, developing the ESM, and fiscal mechanisms. The goal is to make the monetary union more robust - particularly by increasing risk sharing – but without putting in place the wrong incentives, and without creating additional transfers.

Completing Banking Union consists of two steps. First, the Single Resolution Fund needs a financial backstop, so that it has enough money in case of a large crisis. The ESM will provide this backstop, which will become operational in 2024 at the latest.

Secondly, Europe should tackle the issue of a common deposit insurance. This would reduce the risk of national bank runs during a crisis. Of course, banks first need to reduce legacy problems. They have made progress in this area, and should continue to do so. Banks should also strive to reduce holdings of domestic sovereign bonds.

Completing the Banking Union, and creating a Capital Markets Union would help reduce fragmentation and create a true single financial market. Financial market integration is well below the levels of 10 years ago. This limits risk sharing via markets - unlike the U.S., where it works really well, and thus provides quasi-automatic macroeconomic stabilisation.

Developing the ESM is another topic on the agenda to deepen EMU. Four new tasks are under discussion. First, as I said, the ESM will provide the backstop for the SRF. Second, the ESM will play a stronger role in future country programmes, together with the European Commission. Of course, the competences of the Commission as laid out in the EU Treaty will be respected.

Third, the lending toolkit of the ESM is being evaluated. In particular, we are looking at precautionary instruments.

Fourth, there are plans to improve negotiations with private creditors during a debt restructuring. When a country applies for a loan, the ESM would present a debt sustainability analysis, and facilitate the talks between the country and its creditors. This should make the process more transparent and predictable.

Further to this, there are many proposals for fiscal instruments: either for macroeconomic stabilisation or for economic convergence. But there is no consensus yet on this controversial issue.

To my mind, there is only a limited need for additional transfers to improve convergence between countries. Large transfers are already happening through the EU budget. These transfers help countries converge within the EU, and also within the monetary union.

France and Germany recently proposed to create a euro area budget - as part of the EU budget - to promote competitiveness, convergence and stabilisation. This is an important signal, because it shows that the debate about fiscal mechanisms is making progress.

In my view however, what is needed most are new instruments for macroeconomic stabilisation. I say this for three reasons.

First, countries in a monetary union can no longer use monetary policy and foreign exchange policy as tools of macroeconomic stabilisation. Only fiscal policy is left for that purpose.

Second, monetary policy in large economic regions tends to be procyclical. Real interest rates tend to be too low in areas with high growth, and too high in regions with low growth. Fiscal policy may sometimes be needed to address that.

Third, as I already said, economic risk sharing in the euro area is much less developed than in the U.S. The euro area has no common tax and social security systems, which in other large economies help stabilise economic cycles between countries or regions.

Needless to say, countries must fully build up national buffers before they can use a central stabilisation tool. There are several proposals for such tools: supporting investment, reinsuring national unemployment schemes, rainy day funds and short-term ESM loans. But the underlying principle is always the same: to enhance risk sharing between euro area countries. It could help prevent small problems turn into big problems for which an ESM programme might be needed. All proposals under discussion can be constructed without causing permanent transfers.

If we succeed in deepening monetary union further, that would certainly also help in strengthening the euro's global role. I often meet investors who complain about the fragmentation of European capital markets, and the lack of a fiscal capacity.

At the moment, we are witnessing again how the dollar could pose problems for the global economy, because it is the dominant currency of the international monetary system. When the Fed raises interest rates – even if this happens for good reasons – and the dollar appreciates at the same time, this can become a problem for companies and countries holding dollar-denominated debt. Moreover, unfortunately, the Trump administration is increasingly using the dollar as a tool to achieve foreign policy goals.

I believe the time is right to strengthen the international role of the euro. Not only to improve the functioning of the international monetary system, but also to protect Europe's interests.

The euro is clearly the world's second-most important currency. Almost a quarter of foreign currency reserves are held in euros, and its share in global payments reached almost 36 percent in 2017.

The goal should not be to replace the dollar in the future. We should aim for a multipolar system, in which several currencies have a comparable role, including the dollar, euro and renminbi.

Of course, the agenda to deepen monetary union is one crucial pre-condition to achieve that goal. But what is also important is to foster **the integration of**

financial markets.

Europe’s financial markets are far less liquid than in the U.S. and we need to deal with fragmentation in a number of areas. Without properly functioning and liquid financial markets, the euro will never take on an international role comparable to that of the dollar.

This means that banks should rethink their business models. Some countries should reduce overbanking and overbranching. This will boost banks’ profitability, which is lagging behind the U.S.

As part of the Capital Markets Union, bankruptcy, tax and corporate law are partially being harmonised. This will ease cross-border equity investment and open up new ways to finance business. This would again make the euro more attractive for global investors.

On top of that, the **infrastructure of European financial markets** should be developed further. With TARGET2, Europe has a very efficient system for the settlement of payments. But securities settlement is still a very fragmented business, with a multitude of Central Securities Depositories (CSDs). This doesn’t make life any easier, particularly not for investors from outside Europe.

A technology upgrade is also long overdue in the primary market for government bonds. A single distribution platform would offer more transparency and easier access for investors, particularly those abroad. It is also important that public issuers reduce their dependence on the private sector and non-European providers. A strong infrastructure for public sector issuance would reduce vulnerabilities, and give public issuers access to investors abroad, regardless of what third-party countries decide.

The ESM has started to discuss this idea with other public issuers, banks and investors. Together with closer connections between CSDs, a more modern primary market infrastructure would help harmonise European capital markets. Such a system could also strengthen the international role of the euro.

Furthermore, Europe should work to reduce its dependence on a small number of **U.S. IT infrastructure providers**. The fact that only a handful of U.S. players dominate the market for cloud computing implies systemic and data protection risks. A true European provider is nowhere in sight. If an outage hits just one company, this could affect the entire system, and cause an economic shock. Moreover, it seems dangerous to depend on a small number of non-EU providers at a time of rising protectionism. Europe’s strong data protection laws should be seen as a competitive advantage, guaranteeing better consumer protection and ultimately, more stability.

When the euro one day plays a bigger role globally, the ECB would also have to assume a more prominent role towards third-party countries. The Fed’s **dollar swap lines** with the ECB and central banks in many other countries were an important tool during the crisis. But it seems unlikely that the current U.S. Congress would again support them. And so the ECB should take on some of this responsibility once the euro gets a more prominent role. So far, it has only done a limited amount of swap lines with other major central banks, and with EU central banks not part of the euro area.

A safe asset is a final point to promote the role of the euro in the global system. It would be a crucial step to integrate markets, and to make the euro more attractive for international investors. A safe asset would also allow Europe’s banks to reduce their holdings of national debt, and attract international capital to Europe.

But there is no magic potion to create a substantial market for a euro area safe asset. There are some creative academic proposals, which mimic a safe asset using financial engineering techniques. It’s positive that people think about this in a creative way, because having a safe asset would be so important for financial market integration. But so far, their efforts haven’t been successful. Really the only way forward here is to strengthen trust in the national budget policies of euro area countries. Once that happens, part of national debts could perhaps be mutualised in a decade or two.

This would be a crowning achievement of the monetary union. Financial market integration would then be complete, and the international role of the euro would certainly benefit from it.

That may sound optimistic, certainly given what’s happening in Italy at the moment. But when thinking about the future, one must sometimes abstract from what is happening right here and now.

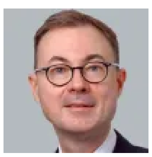
Let me conclude here. The monetary union is now stronger than before the crisis, but there are new risks and challenges. Therefore, it is important to think about deepening EMU further. With a more robust monetary union, the euro could also take on a larger role on the global stage. That would be an important achievement. Not only for Europe. But also for the international monetary system.

Thank you for your attention.

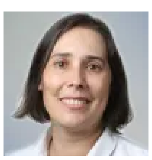
Author

Klaus Regling
Managing Director (2012 - 2022)

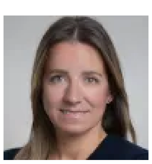
Contacts



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