What comes after the Euro Summit? The role of the ESM in a deepened monetary union - speech by Klaus Regling

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29/01/2019
Speeches
ESM
Brussels, Belgium

Klaus Regling, ESM Managing Director "What comes after the Euro Summit? The role of the ESM in a deepened monetary union "

Representation of the State of North Rhine-Westphalia to the EU
Brussels, 29 January 2019
(*Please check against delivery*)

Dear Minister Lienenkämper,
Ladies and gentlemen,

I am pleased to speak at the representation of North Rhine-Westphalia. Luxembourg and the ESM are closer to North Rhine-Westphalia than you might think. Only a few meters from the building of the ESM – right in the heart of the European quarter – is the "Boulevard Konrad Adenauer". The first Chancellor of Germany is probably the most known Rhinelander. In 1957, he was awarded the Luxembourg Grand Cross of the Order of the Oak Crown. Already as a chancellor, Adenauer supported European integration.

Many years have passed since then. European integration has deepened. At the beginning of this year, we celebrated the 20th anniversary of our common currency. During this period the euro crisis also occurred, which we have now overcome.

The euro crisis has clarified two things: first, there were considerable failures regarding competitiveness, public debt, and real estate bubbles in the first decade in some countries of the currency area. And second, that the monetary union had institutional weaknesses and gaps.

Today, the euro area is better positioned than it was ten years ago. The reason for this is a broad package of measures, which were successful because of their combination. Far-reaching reforms in the member states which received loans from the rescue funds have largely eliminated their problems. The unconventional monetary policy of the European Central Bank (ECB) was another indispensable element to emerge from the crisis. At the same time, the coordination of economic policies at EU level has improved significantly. And the institutional architecture of the currency area has been substantially strengthened by the creation of the Banking Union and of the two rescue funds.

The Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) were created in the framework of the Banking Union.

In 2010, the temporary European Financial Stability Facility (EFSF) was established.

Two years later, the permanent ESM was created.

The ESM was established for a reason: it has closed an institutional gap in the euro area. Before the crisis, there was no "lender of last resort for countries" in the euro area.

Without the creation of rescue funds, former programme countries such as Greece, Ireland and Portugal would probably have had to leave the monetary union. Europe would look different today.

When granting loans, the ESM applies the basic principle used by the International Monetary Fund: loans are only disbursed if the beneficiary country implements extensive reforms.

Although we have informed the public extensively, some people still claim that the ESM programmes are funded by taxpayer money. That is not true. The money for the loans is raised by the rescue funds on the market. Of course, our member states take on risks as shareholders when funds are disbursed. If loans are not repaid, national budgets are liable. But the program countries have to repay their loans in full, including interest.

With around €80 billion, the ESM has the highest paid-in capital of any international financial institution. This serves as security for investors. Because of the paid-in capital, the ESM has an excellent rating and therefore pays low interest rates on the market.

These favourable financing conditions are passed on by the ESM directly to the beneficiary countries while applying strict conditionality. The low interest rates create considerable budgetary savings for the respective countries: this way, for example, Greece saved around €12 billion in 2017. That is almost 7% of Greek economic output. And these savings repeat every year.

Since 2011, the bailout funds have disbursed €295 billion to Ireland, Portugal, Greece, Spain and Cyprus. Today, Ireland, Portugal, Spain and Cyprus are experiencing high growth and rapidly falling unemployment rates. And they can easily refinance themselves on the market again. Greece is also on the right track – provided that the country remains willing to continue reforms.

Much has happened during the last 10 years. And the monetary union is now more stable and better prepared for the next crisis than a decade ago. But the reforms continue, rightly so.

Reform in the euro area: what does this mean for the ESM?

At the meeting of the euro finance ministers a week ago, it became clear that deepening the monetary union is at the top of the European agenda. It involves the completion of the Banking Union, the further development of the ESM and fiscal issues.

First a few words on the further development of the ESM.

The euro finance ministers' proposal to strengthen the ESM was adopted at the Euro Summit in December. What does this mean exactly?

First, the ESM will take on the role of a backstop in bank resolutions in the Banking Union. This backstop would be used when the resources of the Single Resolution Fund are insufficient. I expect that, as in the US, the SRF will only rarely be used. There will also be no additional burden on taxpayers. By 2024 at the latest, the backstop should be fully operational. Right now, we are working on details like the coordination and decision-making processes.

Second, the ESM will play a stronger role in future aid programmes. In collaboration with the European Commission, the ESM will design, negotiate and monitor future assistance programmes. Both institutions agreed on their future cooperation in November 2018.

Third, the "toolkit" of the ESM was reviewed and the precautionary credit lines will be made more efficient. The ESM has different financial assistance instruments at its disposal. Up to now, only two have been used: long-term loans were granted in the framework of an ESM programme, to Greece, Ireland, Portugal and Cyprus and a loan was granted to Spain to recapitalise the banking sector.

It is also part of the adopted proposals to strengthen the role of the ESM in matters of debt sustainability. It is the ESM's duty to always maintain a creditor's perspective. The ESM may only grant loans to member states if their debt is sustainable. In the future, the Commission and the ESM will jointly prepare a debt sustainability analysis. In addition, the ESM may mediate dialogues between member states and creditors in the course of a possible debt restructuring, if required.

In the context of our panel debate, let me say a few words about the often-heard criticism that there is a democratic deficit or accountability deficit at the ESM, because the ESM is intergovernmentally organised. The ESM Treaty is an international treaty. The EU Treaty does not mention the ESM.

In the long-term, I am in favour of integrating the ESM 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 of Governors in which the shareholders are represented. The member states would have the final decision and the involvement of the Bundestag and the other parliaments would be respected.

The ESM recognises the central role of the European Parliament in the public debate on the currency area. That is why I speak voluntarily in the European Parliament, whenever I am invited there for an informal dialogue. I think it is very important to inform the Parliament about our activities and to discuss them. However, for legal reasons the ESM cannot enter into an interinstitutional agreement with the European Parliament comparable to the interinstitutional agreements between the European Parliament, the Council and the European Commission.

The reason is that the ESM is legally outside the institutional framework of the EU. The founding document of the ESM was signed by the euro countries and ratified in their parliaments. The Board of Governors, the highest decision-making body of the ESM, consists of the 19 finance ministers of the euro countries. These ministers are accountable to their national parliaments. That is good because the risks of ESM lending ultimately lie with the budgets of the member states. Thus, I do not see a democratic or accountability deficit at the ESM.

We can certainly further develop our relationship with the European Parliament. The possibility of a Memorandum of Cooperation, as currently discussed in the ECON Committee, seems to be a good option.

Are the envisaged reforms sufficient to make the euro area even more crisis-proof?

Coming back to the reform agenda. The December decisions of the Heads of State and Government to deepen Economic and Monetary Union are another important step towards a more robust monetary union. However, I think there are still a few more necessary and meaningful steps to make the euro area permanently crisis-proof.

In the framework of the Banking Union, a European deposit insurance should be created, even though this subject remains controversial. It was also discussed in the last Eurogroup meeting. A High Level Working Group was set up. It aims to identify a possible way towards a deposit insurance and will deliver an interim report to the Eurogroup in April and the final report in June. I think that is a good development.

Had there been a European deposit insurance several years ago, the volume of all ESM financial assistance would have been significantly lower. A substantial part of the loans was needed to recapitalise banks in the programme countries, due to the fact that worried deposit-holders withdrew their savings during the crisis.

With a common deposit insurance, the fears of savers – that their deposits may not be paid in euros, but in a new, depreciated national currency – would be irrelevant. This would eliminate the reason for national bank runs. A credible deposit insurance would improve the protection of savers across the Banking Union, regardless of where their deposits are located. Hence, it is the best guarantee that it would most likely only rarely be used as experience in the US shows.

At the same time, whenever I argue for a deposit insurance, I always emphasise that the prerequisite for its introduction is a significant reduction in banks' risk exposure. Legacy issues must first be addressed. We should also note that progress has been made:

The core capital ratio of European banks was almost 15% in September 2018. And the volume of non-performing loans fell by around 12% in the euro area last year, and even more in the problem countries.

However, as there are still some countries with legacy issues in their banks, this trend must continue. Additionally, the high proportion of domestic government bonds in bank balance sheets should be reduced.

A European deposit insurance, together with a Capital Markets Union would make the creation of a single European financial market easier. The degree of financial integration in Europe is well below the level it was 10 years ago. As a result of the crisis, there are 19 national financial markets in the monetary union today, we do not have an integrated market. This prevents risk sharing across the markets, which works well in the US and provides for almost automatic macroeconomic stabilisation.

To strengthen the euro area, there are also numerous proposals for new fiscal instruments for macroeconomic stabilisation and convergence of living conditions. But there is still no agreement on this issue among the euro countries. Once again, this became clear in the discussion among the euro finance ministers last week.

I think that additional tools for macroeconomic stabilisation should be considered for the following reasons:

First, in a monetary union, two macroeconomic governance instruments are not available: monetary policy and exchange rate policy. Therefore, only fiscal policy remains to counteract if necessary.

Second, monetary policy tends to be pro-cyclical in a large economic area. Regions or countries with high economic growth and thus higher inflation tend to have low real interest rates. Low growth regions and countries tend to have high real interest rates. We see this in Europe as well as in the US or China. Because of that, it is useful to counteract in terms of fiscal policy.

Third, economic risk-sharing is less developed in the euro area than in the US. This applies to both risk-sharing across the markets and risk-sharing through fiscal mechanisms. In the euro area, there are no common tax and social security systems that permanently stabilise business cycles as in the US states.

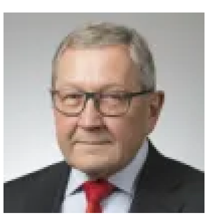
Before any fiscal instrument for macroeconomic stabilisation in the euro area is used, all euro area countries naturally should first use their national fiscal buffers. This is what the Stability and Growth Pact suggests. These buffers must therefore be built up first. But the national buffers could be strengthened by European instruments to have more fiscal space in a crisis.

There are several proposals for macroeconomic stabilisation in the euro area: investment stabilisation, reinsurance of national unemployment schemes, rainy day funds or short-term ESM loans. All these proposals serve the same purpose, namely additional risk-sharing between the member states in the euro area. This would prevent small crises from escalating into major crises in which the ESM would need to be involved. Importantly, all these proposals could be designed so that they do not lead to permanent transfers.

Ladies and gentlemen,

I think we have achieved a lot in the last few years. The euro area today is more robust than it was 10 years ago. But there are still some important steps to be taken, in order to make the currency area more crisis-proof and to further strengthen our common currency. The awareness of this can certainly be raised by discussions such as tonight.

Author



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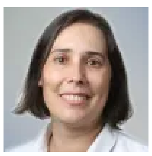

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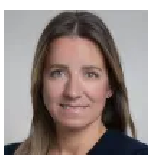

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