“Safeguarding the Euro – the European Stability Mechanism” - speech by Klaus Regling

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Book presentation with Minister Pierre Gramegna
“Safeguarding the Euro – the European Stability Mechanism”

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(Please check against delivery)

Dear Minister of Finance of Luxembourg, dear Pierre, ladies and gentlemen and dear colleagues,

It is a particular pleasure for me to welcome you at our premises to present the ESM history book *“Safeguarding the Euro in Times of Crisis – The Inside Story of the ESM”* . It is a particular pleasure for two reasons: First, because this is our office where we have grown from a start-up institution with a small number of people to the mature institution of today with almost 200 staff from 43 different countries. Second, because Luxembourg has not only been our host-country, but it has also become our home-country, for the ESM as an institution and for many among our staff, who have their families and their lives here. There is strong bond that links us to Luxembourg and we would like to thank you, Pierre, for the unfailing support Luxembourg has always given us since 2010.

You might ask why is the ESM in Luxembourg? As some of you know, the ESM's predecessor, the EFSF was set up as a private company under Luxembourgish law by the euro Member States when the euro crisis threatened the existence of the euro area in June 2010. Everything had to go really fast and one of the few countries where such a company could be set up easily within a very short time was Luxembourg. Also Jean-Claude Juncker, at that time Luxembourg's Prime Minister and Eurogroup President, was always immensely supportive and he still is in his current position as Commission President. A big thank you also to him!

There are other reasons for us to be here: Luxembourg is one of Europe's financial centres. Luxembourg is the home of some important European institutions: the European Investment Bank (EIB) and the European Court of Justice, for example. At the start the EIB was of invaluable help in setting up our fledgling institutions and providing services we were not yet able to perform ourselves.

Let me now turn to our institution today. The ESM was not part of the initial setup of the euro area or the EU. The Maastricht Treaty does not mention the ESM. There was no lender of last resort for sovereigns.

With hindsight, one might wonder why. But the reason is simple: it was not foreseen that a euro area country could lose access to market financing. In other words, it was unthinkable that a member of the Economic and Monetary Union (EMU) would ever find itself on the brink of default. To be fair, nobody expected a crisis like we had eight to ten years ago – the worst economic crisis in Europe in 80 years.

We had to learn the hard way that a backstop is needed in a currency union as the cost of losing market access can be very high. The crisis has shown how interconnected euro area countries are. The resources of the International Monetary Fund (IMF) were insufficient to help euro area countries that lost market access. A euro area institution had to be created to supplement IMF resources.

With the ESM, the euro area now has a lender of last resort for sovereigns. The ECB is “only” the lender of last resort for euro area banks because monetary financing of euro area sovereigns is prohibited for good reasons.

The ESM has established itself as a permanent institution with sufficient firepower and it has worked well. Like the IMF, it disburses loans only against conditionality. That means extensive reforms, as this helps countries to overcome the problems that led to a loss in market access and to return to long-term financial stability.

During the last eight years, both rescue funds disbursed €295 billion to five countries: Ireland, Greece, Spain, Cyprus, and Portugal. This provided essential financing to governments without which some of the countries would have been forced to leave the euro area.

In addition, countries benefit from budgetary savings due to our loans with very long maturities and very low interest rates. The Greek budget, for example, saved €13 billion in 2018, representing 7% of Greek GDP. Greece will enjoy these savings for many years to come, and this is an essential contribution to Greece’s return to debt sustainability.

Today, the euro area is better equipped to deal with a future crisis than ten years ago. But as many policymakers noted in the ESM book – more needs to be done to further strengthen the euro area’s financial architecture. And more is being done.

The current reform debate

The EU Heads of State and Government endorsed a package of reforms last December. This involves the completion of banking union, the further development of the ESM, and more work on a European deposit insurance and a fiscal capacity.

In June, the Eurogroup broadly agreed on the detailed proposals to enhance the ESM’s role. This will imply the following steps for the ESM.

First, the ESM will provide the backstop to the Single Resolution Fund (SRF). The backstop will be “fiscally neutral”. This means that there will be no burden on taxpayers. If the backstop is needed, repayments will come from the banking industry. By 2024 at the latest, the backstop should be fully operational with a volume of €55-60 billion.

Second, the ESM will play a stronger role in future economic adjustment programmes. Together with the European Commission, the ESM will design, negotiate and monitor future programmes.

Third, the ESM’s has reviewed its financial instruments. Following the review of our toolbox, the precautionary credit lines will be easier to use.

Fourth, the ESM could, upon request, facilitate the dialogue between a euro area country and private investors if a debt restructuring is needed. A new Collective Action Clause (CAC) will be introduced to euro area sovereign bonds. It will make life more difficult for hold-outs.

These new tasks are included in a revised draft of the ESM Treaty, which will come into force after being ratified by the national parliaments of all 19 ESM Member States. The ratification process could start in December 2019 and last 12-18 months.

How much backstop does the EMU need?

It is evident that since 2010, Europe has accomplished a great deal in strengthening EMU. However, I think there are still a few more steps needed to make the euro area crisis-proof in the future.

In my view, we are still missing three backstops:

First, a backstop to ensure depositor protection in the euro area regardless of the location of the bank. With an identical level of depositor protection across the euro area and a weaker link between banks and sovereigns, financial fragmentation would decrease, and so would the risk of bank runs in a crisis. If we had had a European deposit insurance during the last ten years, all ESM programmes could have been substantially smaller.

These are good reasons to create a European deposit insurance. But for this to happen, euro countries need to agree on a mutually acceptable balance between risk-reduction and risk-sharing. This implies that legacy problems in some countries must be tackled – meaning a further reduction in non-performing loans and a re-balancing of banks' exposure to their own government bonds in their balance sheets.

The second would be a backstop for liquidity in resolution. The completion of banking union also requires addressing the remaining risks of a liquidity gap in and after resolution. Different proposals to address the possible liquidity shortfall are currently being discussed.

As for a euro area budget, it is reasonable to allocate budgetary resources to an improvement of convergence and competitiveness. This is what the Eurogroup discusses now.

But in my view, a third backstop – for macroeconomic stabilisation – is also needed. This is very controversial. But this is perhaps the final element missing in the architecture of our monetary union. This would be useful because countries that are members of a monetary union give up two other key macroeconomic policy instruments: monetary policy and exchange rate policy. Such a tool could be designed without creating additional transfers. We do not need an annual budget for macroeconomic stabilisation but a revolving fund.

Conclusion

These three backstops would make monetary union even stronger and more crisis-resilient over time. And they would contribute to a stronger international role of the euro as international investors are waiting that these gaps are closed.

I will conclude here and I am looking forward to the remarks by Minister Gramegna and the discussion. If you have not yet done so, please pick up a copy of the book after our discussion. I hope you enjoy it!

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