Klaus Regling in interview with Helsingin Sanomat (Finland)

View PDF
03/10/2019
Interviews
ESM

Interview with Klaus Regling, ESM Managing Director
Published by *Helsingin Sanomat* (Finland)
Interview conducted on 30 September 2019, published on 3 October 2019
Interviewer: Jarno Hartikainen
Original language: English

Helsingin Sanomat: I'd like to start with a question of a joint fiscal capacity for euro zone. Just this morning, Mario Draghi said in an interview that euro zone needs to have a common budget. From ECB's point of view a coordinated fiscal response would support monetary policy and make EMU stronger. What's the ESM's view on this: can we have a strong EMU without a common budget?

Klaus Regling: We have a strong monetary union now and there's no common budget, so it's possible. Also, monetary union today is stronger than 10 years ago. But if you think about ways to make it even stronger – because one day there will be another crisis, not very soon, but one day – then I think that indeed this would be one element. Other elements are completing banking union and capital market union in order to get rid of the fragmented financial sector that we currently have. A fiscal capacity should be part of that, in my view, if we want to make monetary union more robust.

Countries that join the monetary union give up two macroeconomic instrument, monetary policy and exchange rate policy. There's only one macroeconomic policy instrument left, and that is fiscal policy. So that's one reason. Given that the two other instruments are gone maybe this last remaining instrument is needed a bit more often. Another reason is that monetary policy in a big monetary union or big country like US or China, quite often is pro-cyclical. That means that countries or regions that do well with high growth and high inflation have a real interest rate that is lower than it should be. The opposite is true for countries and regions that don’t do so well – lower growth, lower inflation – they have real interest rate that is too high for these countries. This is unavoidable. If the monetary policy is perfect for a region as a whole, it may be pro-cyclical for some parts. These parts may need some fiscal action. Of course, they should first create national fiscal buffers, which is one idea behind the stability and growth pact. These fiscal buffers should be used first. But we know that crises can be so big that this may not be not enough. Then one should have an additional European fiscal buffers as a second line of defense. The first line of defense is the national buffer, but the second could be a European one.

Now, some people are worried that this creates moral-hazard and free-rider problems. But it’s important how such an instrument is designed. There are many proposals on the table. My view is that we don’t need a euro area budget, because a budget has annual inflows and outflows, that’s what people understand when they talk about a budget. But for a macro-economic stabilization there will be many years when we don’t need any expenditure. So in my view we need a revolving fund which is not used in many years but when there is a crisis then it can be activated. Then the money should be repaid within the cycle. So the revolving fund is replenished, and money can be used in the next crises for another country. All countries benefit eventually and there are no transfers. There are several proposals on the table: The Commission proposed an Investment Stabilisation Fund, the German Finance Minister proposed a reinsurance for national unemployment systems, the IMF has proposed a rainy day fund, the ESM could offer short-term facilities. They sound like very different schemes, but they all have the same objective to help macro-economic stabilization and they all could be designed so that there are no permanent transfers.

So these would be loans?

Yes.

If there would be a fund, how big should it be to be credible and to have enough firepower?

Probably 1 to 2 percent of GDP of the Euro area which means € 100 to 200 billion euros. And the money would not be lost, it would be revolving and replenished. But that would be an amount that would impress markets and also do its job by stabilizing parts of monetary union. Another argument is that this would impress markets and would help therefore to increase the international role of the euro. Because markets are discussing these topics. There are still gaps in the architecture of monetary union. Banking union is not complete, capital markets union is not there. That's how the markets look at it. I know it from my frequent interactions with international investors when we issue bonds. So that would also help to stabilize market expectations and strengthen the confidence the rest of the world has in the functioning of monetary union.

Your idea of a macro-economic stabilization instrument is a bit different from a eurozone budget, which could be used counter-cyclically. What you have in your mind is a crisis-prevention system.

Yes. It would only be activated when there is a problem. But it could be activated very quickly. For example, the reinsurance of national unemployment system could kick in automatically when unemployment reaches a certain threshold. But indeed there would be a difference compared to a budget, because there are many years when it's not needed, while a euro area budget would be something that's used on an annual basis, money gets spent every year. It has less to do with macro-economic stabilization. It might be very useful for other purposes, for instance to finance common efforts preventing climate change or defending common borders or fighting terrorism. So there could be common expenditures for common public goods, but it has less to do with macro-economic stabilization. Except if the expenditure side is fixed as a certain percentage of GDP and the revenue side fluctuates so that countries that enter a crisis pay less while the common budget remains the same on the expenditure side. That way the stabilization would come from the revenue side. That is also a very useful thought that should be discussed.

In what kind of circumstances could the macro-economic stabilization instrument be useful?

Certainly when there's what economists call an asymmetric shock. One example would be that if there's hard Brexit. We know Ireland would be hit more than any other European country because they have very close trade relations with the UK. At the moment Ireland is in very strong situation, they might not need any help, they can use their national buffers. But if there would be a need for more, then such European buffer could help. But more broadly we can compare this to the US. They are a big economy and therefore sometimes it's good to look at them. In the US, they have a common tax system and common social security system. There you can find automatic stabilization when the business cycle in some regions deviates from other regions, for example when the car industry in the Midwest turns into a rust belt, then there are automatic stabilization mechanisms unfolding. Nobody needs to decide anything, it just happens. Because if the regions in the Midwest don't do as well as Florida or California, then there will be less tax payments from the companies there and people living there to the center, and they may receive additional social security. Also via markets companies located in the regions that don't do well pay less dividend. That means less dividends for people who own those stocks and may live in in Florida and California. These are underlying relations and channels that we don't have in the monetary union, but we can copy them to some extent, but not fully, because we don't have a common tax and social security system. But to some extrent we can organize similar effects by creating the instruments I described.

I still want to go back to the question of moral hazard. As you are well aware, it is a constant worry in Finland and other Northern countries whenever there's discussion on new risk-sharing instruments. So, only the fact that money would be in the form of loan should prevent moral hazard problems, am I getting this right?

It is a strong argument, but one can do more. I'm not criticizing anyone who talks about moral hazard because that is a very relevant economic concept. When the ESM was created, many people were worried that it would create wrong incentives and moral hazard. But I think the last 10 years have shown we are using the money from the ESM in a way that there are really no moral hazard concerns left or they are minimized. We only provide money against conditionality. We discuss with the country a reform package, and only if these reforms are implemented money will be disbursed. This is the same concept the IMF has used for 60 years. So my institution is a good example, because many people were worried – and rightly so – about moral hazard issues, but we operated in a way that these concerns were removed. Similarly, if one has a reinsurance of national unemployment systems, this would be a loan that has to be repaid. So one can design it in a way that moral hazard issues are minimized.

Another issue I wanted to bring up with you is the reform of EU's fiscal rules. There seems to be a consensus that the rules need to be reformed, but there's disagreement on how they should be changed. From your point of view, what are the most urgent needs?

I'm afraid it's even more difficult, because there is not even consensus that the rules should be reformed. We had the discussion on that at the informal Ecofin meeting in Helsinki two weeks ago, and there are a number of member states that say – and they have good arguments – that it would be too difficult to reform the rules. The French finance minister said that we would spend so much of our time and energy doing that because it will be so difficult. And he's right, it will be difficult. It's not easy to move from one system – and I was there when it was created 25 years ago: it took many, many nights, many summits and finance ministers' meetings to have it ready in the end – to move to a new system that replaces the old one. One should have no illusions: it will not be easy. Another argument is that the zurrend system has not worked perfectly, far from it, but it has worked to some extent, and that should not be ignored. It really has worked to some extent. Look at two years: The first is 2008, the last year before the global crisis and in that year Europe, like other countries, came out from a 5-6 year-long boom period. It's a quite interesting comparison that in the euro are we had a fiscal deficit of 0,5 % of GDP that year. If the stability and growth pact had worked 100 percent, it should have been a 0,5 % surplus instead of a deficit, so it has not worked 100 %, that is very clear. But the US, Japan, UK, they all had fiscal deficits between 2,5—3,0 percent in 2008. I think one can argue that the fact that we did better than the others was the result of having the Stability and Growth Pact (SPG), because every country is permanently reminded we have these rules and the finance ministers discuss this every month in the Euro group. So it has an impact, it's not perfect, but it has a positive impact. It's the same thing now, when we basically have a balanced budget in the euro area. Of course its distribution isn't very even, but no country is above 3 %, while the US has a deficit above 6 % and Japan around 4 %. So again, not perfect, but it's not as bad as its reputation. That should be kept in mind. But I think we should still work on the reform for two reasons. One is that the rules have become very complicated. There are many exceptions to the rules, and by the way, one should not blame the commission for that, these exceptions were decided by the Ecofin council, and the Commission has to implement it. Now it has become so complicated that hardly anyone understands everything. Then it's very easy to say it's not very well implemented. The other reason is that the SGP and some of its core data relies on unobservable variables, so definitions that can only be estimated, not measured, particularly the structural balance or the underlying fiscal balance regardless of where in the cycle the country is. For that one needs to estimate the output gap and potential growth rate, and that is not working well at the moment. We had a system that worked before the crisis, but with the crisis the relationships have broken down in many countries, so we are trying to estimate something and we aren't really able to do it. That is another reason to think about the reform. So unfortunately it's a quite complicated issue.

I understand that when it comes to the reform, we're talking more about technical details, but should we amend the thresholds, 3 % for deficit and 60 % for debt?

It's not really feasible, because those numbers are mentioned in the Maastricht Treaty. If we want to change those numbers, we need to change the EU treaty, and that's not possible in the next few years. So that is not the way to go. But one can do two things, and those who are advocating a reform are relying on that. We have to rely more on observable variables. One that would be useful is to have an expansion path for expenditures, for example that public expenditures should not grow faster than trend growth. That is easy to observe. The parliament also needs a variable that they can look at from year to year. So that's one thing, to move away from unobservable variables. Also, we probably need to get rid of some the exceptions that were created in the last few of years and instead have a more general escape clause. If there's a political consensus that there's a special situation and one can temporarily deviate, that decision can be taken instead of relying on a dozen complicated rules that not many people understands.

Should the aim of the reform of fiscal rules be that member states get more leeway in their public finances?

Not in general. I think the general objective of the SGP is the right one: to limit the fiscal deficits in order to not have excessive debt levels. That is still a good purpose. Of course we now have countries with debt levels brought below 60 percent, and they have more leeway, including Germany and Finland and a few others. But that's already captured by the SGP as it is. Then countries can have small deficits, and of course, when the cycle turns down, the automatic stabilizers can work, and they are quite strong in some countries, and the deficit can go up to 3 percent to GDP. In addition, the pact always had the exceptional circumstance clause, an escape clause, when times are very difficult and something exceptional happens, which could be natural disasters or a financial crises like in late 2008, then it was rightly decided that all countries should for while ignore the 3 % limit and have higher deficit. That was a unanimous decision and it was the right one. That’s captured by the pact. So there’s flexibility to deal with special situations. So the difficulty is more with countries that have a high deficit, how quickly to bring it down, or those that are below 3 percent but are not in the normal situation which is a balanced budget or a small deficit. That’s where the political battles are often today. With the many exceptions people often don’t know why the commission takes certain decisions. They have their reasons but it’s so complex, based on such a complicated framework, that that is a reason for a reform.

This is another point that I wanted to raise, about the supervision of the rules. Not everyone is happy with the way the European Commission has handled this task and there are proposals that the supervision should be transferred to another institution like ESM. What is your response?

A: That would very clearly require a change of the EU treaty, because the EU treaty gives the responsibility of economic policy coordination and monitoring and implementing the fiscal framework to the commission. So even if the Euro Group decided unanimously to change that, they are not allowed to do that. It’s legally not possible. So I think one should leave that with the Commission. I worked there myself, I know they can do good job. Maybe make their life a bit easier by reforming the rules and having fewer exceptions. Because the life of the commission became so complicated when the council created these exceptions. When I was in the commission, it was still the old pact, with fewer exceptions, only the big one for exceptional circumstances, and therefore it was much easier to come to a clear conclusion on where different countries stood and whether they were violating the pact or not. Today this is much more difficult to understand.

So the problem lies not with the Commission but with the rules themselves?

One can also be unhappy how they implement the rules, but one has to realize that the council took the decision that now makes the life of the commission very complicated, much more difficult than it was 10 years ago.

It's interesting that the a few years ago the fiscal rules were described as stupid, but nobody calls them intelligent now, only too complex.

I thought it was not a good comment at the time from Romano Prodi, the Commission president at that time, but there is a kind of trade-off. If one wants to have a rule for every possible constellation, then it becomes very complex and there are not many people left who understand it. If it's simpler, then it may not fit all circumstances. So there is a trade-off, and one has to have that in mind when thinking about how the reform might look like. That is why some people have proposed to have only one escape clause that can be activated by a large majority if one thinks that is necessary.

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

George Matlock
Senior Financial Spokesperson
+352 260 962 232
g.matlock@esm.europa.eu