THE EURO AND THE FUTURE OF EUROPE

Klaus Regling

CEO of the EFSF

International Institute for Strategic Studies - Asia

Mumbai, August 21, 2012

Dear Governor Subbarao, dear John Chipman, dear Sanjaya Baru, ladies and gentlemen,

It is a great pleasure to be invited to deliver the first IISS Oberoi Lecture. It is a particular honour to be here in Mumbai a few days after India's 65th anniversary as an independent state on which I want to congratulate all of you!

As you all know, we live in a globalised world where inter-connectedness and mutual dependence are on an ever increasing trend. Where better to see that than here in Mumbai!

Globalisation can be very enjoyable during good times. It becomes much more complex during difficult times. As we are entering a difficult patch in the world economy, with a simultaneous slow-down in many developed and emerging economies, it is all the more important to be well informed about developments in different parts of the world. It is in this spirit that I want to offer you my thoughts about the situation in Europe, the euro and the future of European integration.

Many believe that Europe is in a big mess. The sovereign debt crisis has lasted three years and there seems to be no end in sight. Every day I see headlines and market commentary about the imminent break-up of the euro area; Greece exiting the euro; fiscal adjustment and improvements in competitiveness which were possible in Northern Europe but are, allegedly, not possible in the South; another rating downgrade; another increase in spreads; too small firewalls in Europe; too little action too late by political leaders. I am sure such comments are familiar to all of you.

Has then the creation of the Economic and Monetary Union, EMU, been a mistake, a failure?

No, it has not! The euro is a currency that is the outcome of a long history of monetary and economic cooperation and integration dating back to the collapse of the Bretton Woods system in 1971. Even during the 70s, after the collapse of the Bretton Woods system, European countries tried to limit changes in the exchange rates of their different currencies in order to protect intra-European trade. In 1979 the European Exchange Rate Mechanism was created. European monetary cooperation has survived many crisis and the Maastricht Treaty ratified 1992 paved the way for the creation of the euro. The eventual launch of the EMU in 1999 was only possible because of this long history of increasing integration and convergence. The euro is the result of a process that lasted four decades and its importance for Europe has to be assessed in this long-term perspective.

It would also be a mistake to see the euro narrowly, exclusively as a project of economics. The euro is one of the defining pillars of today's European Union. Of a union, which is alsodeveloping a common foreign and defence policy; which fights cross-border crime and terrorism; which is based on shared values, democracy and legal certainty. In addition to open borders and the Single Market.This is the context against which Economic and Monetary Union (EMU) must be seen.

However, we are in a crisis in Europe and there are reasons for the crisis. Easy access to borrowing helped governments to postpone needed reforms. Economic policies did not take sufficiently into account the constraints of being a member of EMU and sharing one currency. Too low risk premia and too little differentiation during the boom years revealed the markets' failure to price risks properly. Too much leveraging during "good times" has resulted in debt overhang in many parts of the euro area. The global financial crisis exposed the home-grown weaknesses in Europe in the same way as it revealed problems elsewhere.

What has been the European response at the national and union level to get its house in order again? What is the vision of the future Europe and how can we get there? Let me address these questions in turn with the focus on Europe and global implications in the background.

The response at the national level

Let me turn now to the present situation in Europe. I will use this opportunity to challenge mainstream media and market wisdom by demonstrating to you that the European adjustment strategy is delivering results. Despite the lack of confidence of market participants and the scepticism of the broad public, Member States of the euro area and the European Union have made significant progress at the national level towards reducing macroeconomic imbalances. In addition, economic surveillance has been strengthened, more efficient financial market supervision is being put in place, and several institutional gaps are being closed. The reforms, implemented at national level, in conjunction with the strengthening of economic governance and growth-enhancing measures taken at EU level have started to deliver results.

Let me offer some facts to convince you.

First, the euro area as a whole had a fiscal deficit of about 4% in 2011, down from more than 6% in 2009-2010 and this is less than half of the deficits of the US or Japan. The euro area is projected to have a fiscal deficit below 3% of GDP next year. Most importantly, the countries in the periphery have delivered sizable fiscal adjustment and deficits are on an improving trend in all programme countries, with Greece continuing to face the biggest challenges. Spain and Italy have started far-reaching consolidation and reform programmes to reform labour markets, pension systems, and crack down on tax evasion. Indeed, Italy is expected to have its budget balanced in 2013.

All EU member states have budgetary consolidation paths in place with a clear objective to reach a balanced budget during the next few years. I am confident that if countries stick to their adjustment programmes and time passes, incoming data will validate quarter by quarter that the situation is stabilising and Europe has turned the corner for the better. You will then see confidence slowly returning, reducing volatility and yields. We just need a little more patience here and we need to work hard on remaining problems.

Second, with significant adjustment at the national level, macroeconomic imbalances within the Euro area are clearly declining. Europe has suffered from substantial internal imbalances. Indeed, large current account deficits and large divergences in competitiveness were symptoms of past excesses. However, current account deficits and competitiveness of the Eurozone's peripheral economies have been improving significantly during the past 3 years. Ireland shows now a current account surplus after sizable deficits in earlier years, Spain is getting very close to a current account balance after deficits of 10% in 2007 and 2008. Also Greece and Portugal have reduced their current account deficits by two thirds. This is due to export growth in all Southern European countries rather than import compression. As important, the current account surplus of Germany is steadily declining. Likewise, nominal unit labour costs have declined significantly in the periphery and are increasing in Germany, underpinning the story of rebalancing. The competitiveness gap between Northern Europe and Southern Europe that amounted to nearly 50 pp. in 2007-08 has been cut in half. This demonstrates significant progress on the one hand but, also, that countries in the periphery need to continue their adjustment process.

Third, repair of the European banking system is advancing and banks' capitalization improving. All major European banks that had been identified having a capital shortfall have raised their capitalization to comply with stricter rules and met the 9% tier one capital requirement by end-June 2012. Three-quarters of the additional capital requirement came from capital increases and only a quarter through the reduction in assets, thus avoiding excessive deleveraging. Spain is due to receive up to 100 billion euros (equivalent to 10% of its GDP) to recapitalize its banking sector, which has suffered from the bursting of the property bubble. Bank recapitalization has been a major element also in the Irish, Greek, and Portuguese programmes and will be so in the Cypriot programme, which is under consideration. As a result, European banks will be on a much sounder footing, ready and able to finance the real economy.

Fourth, inflation risks in the euro area are well contained with headline inflation on average just slightly above 2%. The risk of deflation – often emphasised by Anglo-Saxon analysts but also the IMF in its latest Article IV review - is minimal.

The adjustment path I described is needed to undo past excesses, but it does mean, unfortunately, that Europe is slow to return to growth. Undoing excesses of the past implies contraction in output in the short term. This path to a new equilibrium with lower real income is very similar to post-crisis years in earlier crises episodes – for example the Asian and Russian crises of 1997-98 or Turkey in 1999-2000 or crises in Latin America in the 80s and 90s. Real incomes need to shrink to regain competitiveness and while this happens, domestic demand and GDP growth are low or negative. While painful, it is necessary to build a solid foundation for sustainable growth in the future. There is no real alternative for solving the problem of debt overhang and regaining fiscal and financial stability.

I disagree with those who argue that a devaluation would be an easier way out to improve competitiveness. It wasn't so in 1990s, and it is not so now. It is the structural reforms which make countries competitive in a sustainable way – in the past and again now. As devaluations are not possible anyway in the monetary union, cuts in nominal income are an inevitable part of the adjustment process. I know this view is against Anglo-Saxon textbooks, but those textbooks may have to be rewritten as European countries demonstrate that cuts in nominal income can improve competitiveness quickly.

If the adjustment and reforms are duly implemented, Europe will be back on its long-term potential growth path of the order of 1-2%, barring the world economy being hit by other shocks. For many, this growth rate may seem like underperformance, but let's be realistic. At Europe's level of GDP-per-capita, which is close to the global technological frontier, and given our negative demographic trends, 1-2% real growth is what the euro area can sustainably achieve over the next decade. Remember, on a per-capita-basis, growth in Europe and the United States has been identical during the last 20 years.

Of course, it is true that weaker demand from Europe has an impact on many exporting countries, including India, and world trade. Europe still represents 20% of the global economy and the EU is the largest trading partner for most countries around the world. However, the flip side of the coin is that the bubble years until 2007 inflated global demand above sustainable trend.

The response at EU level

Ladies and gentlemen,

I have tried to explain that the response to the crisis at the national level has been significant and results are increasingly visible, even though widely ignored. It is the combination of these national reforms and strengthened economic governance at European level that is the key to overcoming the sovereign debt crisis. And this is what is happening. Market pressure has been an important driver for reforms, which not only involves fiscal consolidation, current account adjustment, and improvements in competitiveness as discussed earlier, but, equally importantly, improving the governance of the European Union.

European governments have done a great deal to address the problems that accumulated during the first decade of Economic and Monetary Union and which became so visible during the global crisis. They have identified the main weaknesses – at national and European level - and they are tackling them in a way that will profoundly change governance and economic policy-making in the euro area.

First, we have in Europe agreed on the so-called “fiscal compact”. This new Treaty which is in the final stage of ratification by all euro area member states and eight other EU countries provides for strengthened coordination of fiscal and economic policy. It sets out binding budgetary rules including automatic sanctions, which Member States will enshrine in their national legislation. This will help to put government finances on a sustainable footing. It is an important step towards creating a stability union and resolving the sovereign debt crisis.

The fiscal compact strengthens the Stability and Growth Pact and enhances deeper fiscal coordination. Member States are required to make significant progress towards balanced budgetary positions. Expenditure benchmarks will now be used alongside the structural budget balance to assess adjustments towards the balanced budget. Furthermore - for the first time - a controlled reduction of the debt ratio to 60% of GDP is required. Both the reduction of the deficit and the reduction of total debt are subject to a new sanctions procedure. Resolutions proposed by the European Commission can be adopted even against a majority of euro area countries. This reduces the possibility of political interference significantly.

Second, the “European Semester” represents another major improvement. In the first half of every year the Member States’ budgetary and structural policies are reviewed by the Commission and partner countries. It will enable consistent policy guidance early enough, so that Member States can take this into account when they adopt budgets in their national Parliaments for the following year.

The European Semester recasts in a very substantial way how the euro area conducts its policy-making. For the first time, spill-over effects to other Member States will be taken into account before national budgets are decided by parliaments. The European Commission has pushed for this approach for many years but evidently a crisis was needed for the Member States to give up their resistance.

Third, a new macroeconomic imbalances procedure will complement the fiscal compact by aiming to detect and avoid excessive imbalances. Where excessive imbalances exist, repeated failures to follow recommendations by the European Commission will result in sanctions. Although all Member States will be analysed, the procedure is clearly focussed on Member States with weak competitiveness and large current account deficits. Again, Europe is closing a structural gap. In the past, imbalances could become excessive – and we know they did – as there was no designated procedure to address them.

And **fourth**, last but not least, Europe has created strong firewalls. The establishment of a robust euro area crisis management framework has filled in a missing piece from the original design of EMU. Financial crisis management mechanisms – the current EFSF and the future ESM – form the centrepiece of this framework and serve as powerful financial backstops. They buy time for euro area Member States to do their homework – as the IMF does globally.

Let me put the financial side of the European response in perspective. By providing financial assistance to troubled euro area members and committing to lend money in support of the global economy through the IMF, Europe has mobilized about $1.5 trillion, of which two thirds are still available for disbursement.

Europe has committed € 197 bn to the two Greek assistance packages, €45 bn to Ireland, and €52 bn to Portugal, it has agreed to lend up to €100 bn for the recapitalization of Spanish banks. This is almost twice the amount the IMF has currently committed to the financing of adjustment programmes worldwide, including those in Europe.

The ESM, when ratified next month, stands ready to provide €500 bn in fresh money which comes in addition to the existing €192 bn in EFSF commitments for Greece, Ireland, and Portugal. Also the ECB has intervened on the secondary market, purchasing bonds for €220 bn.

Two weeks ago, the ECB made it clear that it will not accept higher sovereign bond yields attributable to fears of the break-up of the euro. The euro is irreversible. The ECB decided it may undertake outright open market operations of a size adequate to reach this objective. However, in the future, any intervention from the ECB to support a particular member state will be conditional on the involvement of the EFSF/ESM and thus subject to strict and effective conditionality. The ECB and the EFSF/ESM are ready to act in concert if a member state requests financial assistance, thus ensuring credibility while alleviating market fears about the size of the firewall.

The success of the EFSF as an issuer is of fundamental importance for Greece, Portugal, Ireland, Spain, and to any new client country. These countries benefit directly from the low interest rates the EFSF is paying as the cost of funding – below 2 ½% for 10 year bonds and at negative rates for 3 and 6-month bills – is directly passed through. As a consequence, the EFSF's success in issuance delivers substantial budgetary saving for benficiary countries.

The EFSF has become an established issuer in the sovereign, supranational and agency category. We have been able to issue at competitive terms even in the most difficult market conditions. Our client base is large and well-diversified both geographically and in terms of investor type. Our latest 3-year bond auction on July 31 was oversubscribed 3.7 times with an average yield of 0.54%. Only very few top rated sovereigns pay less.

We have also first signs in markets that the European response is working at country level. Ireland has taken its first steps to return to the market by successfully placing its first 5-year bond after being cut off from market based financing for about 1 ½ years.

Now, have all the problems been solved? The answer is "no", but Europe is moving in the right direction. Europe has committed to do whatever is necessary to safeguard the euro and the financial stability of the euro area. Trust me – we mean it. And we have the means and resources to deliver on it.

The vision

What is the vision of the future Europe and how can we get there? Discussions are under way to advance with four unions: banking union, fiscal union, economic union and, in parallel, political union.

The **first** of the four unions, banking union stands on three building blocks: a single European banking supervisor, a common EU deposit guarantee fund and a resolution framework. The banking union should include all euro area members, but it may be open for other EU member states who wish to join later. During the euro area Summit in June, there was a clear decision, as a first step, to proceed swiftly with the establishment of the single supervisor. The European Central Bank will have a leading function in this regard and ultimate responsibility at European level. National supervisors who possess the knowledge of financial institutions and local circumstances will be involved in the implementation of pan-European supervision.

One could envision the ESM taking the lead in implementing another building block – operating a common deposit guarantee fund and resolution framework. This has not been decided but once the single European supervisor is established and if the ESM is mandated to participate in bank recapitalizations directly, these tasks would create complementarity and synergy.

Second, several proposals are under consideration to move towards stronger fiscal union. If the improved fiscal coordination rules which I described are fully implemented, the euro area will function better. However, markets have become so sceptical about the design of the euro that a qualitative jump towards fiscal and economic union may be needed. Hence, while many important steps towards better fiscal governance of the euro area have already been taken, the pooling of decision making and, ultimately, pooling of risks could be pursued further. However, a further pooling of risks would not be adequate before today's crisis is resolved and enhanced coordination and stricter enforcement of rules have become an established practice. It means for example a greater ex ante say at the collective level over individual member's debt and deficits.

Third, stronger economic union assumes advanced economic policy coordination and further integration of markets. We have learned a bitter and expensive lesson of limited policy coordination, which resulted in significant macroeconomic imbalances and misallocation of investment. To fully unleash the potential of our Single Market with 500 million citizens, we in Europe need to tear down the remaining walls that hamper cross-border trade and commerce. Opening up closed professions, promoting e-commerce and lifelong learning are just a few essential steps to make sure that Europe exploits its growth potential fully.

Finally – and the crisis has made it clear – we need a stronger political union.

Stronger union rests on stronger legitimacy, stronger democratic foundation and a clear roadmap indicating how we will get there. To make sure that European citizens have a greater say in electing the leadership and the elected have a clear accountability.

The ratification process of the ESM Treaty has already sparked a debate in many European countries over the balance of powers of national parliaments and collective decision making at European level. In my own country Germany, as well as in Estonia and Ireland, the legitimacy of the ESM was brought before the constitutional courts. The role of the European Parliament, in cooperation with national parliaments will become ever more important in the future. Proposals are also on the table to elect directly, by the entire population, a President with an enhanced executive role, combining the roles of today's Commission President and the EU President.

One has to be realistic about the timeline for these proposals – it could take a decade to implement these ideas into reality as changes in the EU Treaty and national constitutions are required. But Europe is determined to begin that process now and the European Summit will examine proposals at their meetings in October and December.

***

Let me conclude. A strong and stable euro area is in the interest of Europe; it is also in the interest of the rest of the world. Since the begin of European integration more than 60 years ago, the ultimate goal of the European project has always been to bring prosperity and stability across Europe while being a reliable partner for the world. Great efforts have been made at the national and the European level to overcome the current crisis. Institutional gaps in the initial design of EMU are being closed.

I am confident that a year from now you will be hearing more good news from Europe as hard data will show progress in overcoming macro-economic imbalances and additional decisions on our move towards a banking, fiscal, economic and political union are adopted. In responding to the crisis, Europe is taking historic steps. This will ultimately benefit its citizens and the world at large.