



“The European Crisis Outlook and its Implications on Asia”

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European Stability Mechanism



Economic and Monetary Union (EMU): more than a currency union

- EMU is the result of **a long integration process**
 - History dates back to collapse of Bretton Woods system in 1971
 - European Exchange Rate Mechanism was established in 1979
 - The Maastricht Treaty, the legal basis for EMU, was signed in 1992
 - In 1999 EMU was launched
- EMU is the result of **sustained economic convergence**
 - The start of EMU with originally 11 countries was possible only after a long process of economic convergence
 - Today EMU has 17 member countries
- EMU is **also a political project**
 - EMU is not a narrowly defined economic project
 - There is a deep political commitment of a large part of the European political elites
 - For many Europeans EMU is a first step on the way to a political union in Europe

Euro area members pool some sovereignty but EMU is not a state

- EMU has an **institutional set-up unlike any other currency area**
 - The European Central Bank (ECB) is a federal institution comparable to national central banks in other countries. It is in total control of the euro area's monetary policy
 - There is no corresponding euro area finance ministry. The 17 national finance ministers retain sovereignty over national budgets and economic policy
 - However all euro area member states have committed themselves to respect a set of budgetary rules and to tightly coordinate their economic policies. The finance ministers do so in the „Eurogroup“
 - The EU Commission monitors the respect and implementation of these rules, issues recommendations and can use escalating sanctions
- Original EMU set-up contained **institutional gaps**
 - EMU as designed by 1999 did not foresee a situation where member states would not be able to raise funds in the markets anymore. No emergency loan system and no backstop were in place
 - Rules for economic policy coordination were too narrow

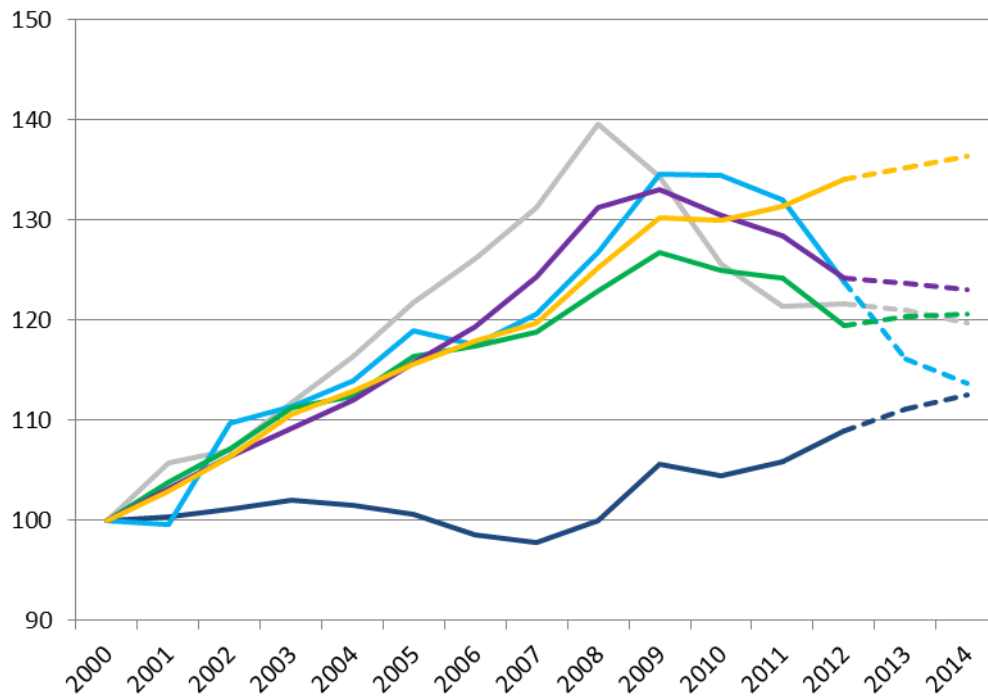
Europe reacts to the euro crisis at national and EU level

- 1) Significant fiscal consolidation and structural reforms at national level
- 2) Improved economic policy coordination in the euro area
- 3) Reinforcing the banking system
- 4) Financial backstops (EFSF and ESM)
- 5) Focus now on growth

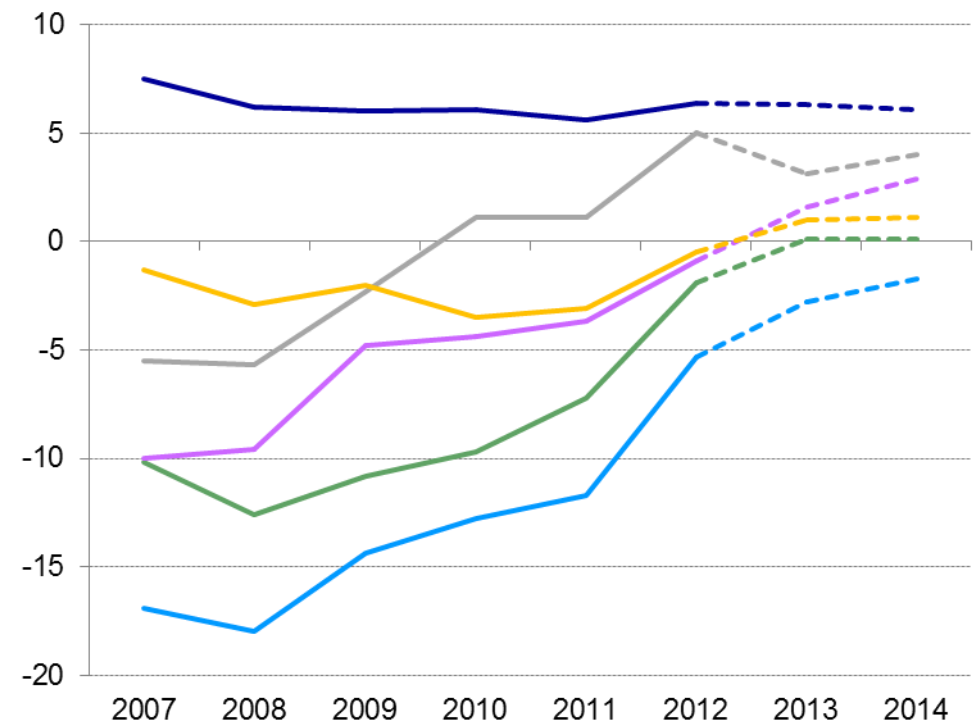
The strategy is delivering results - competitiveness

- Divergences within EMU are declining
- Competitiveness is improving in all Southern European countries

Nominal unit labour costs, whole economy
(2000=100)



Current Account Balance (as % of GDP)

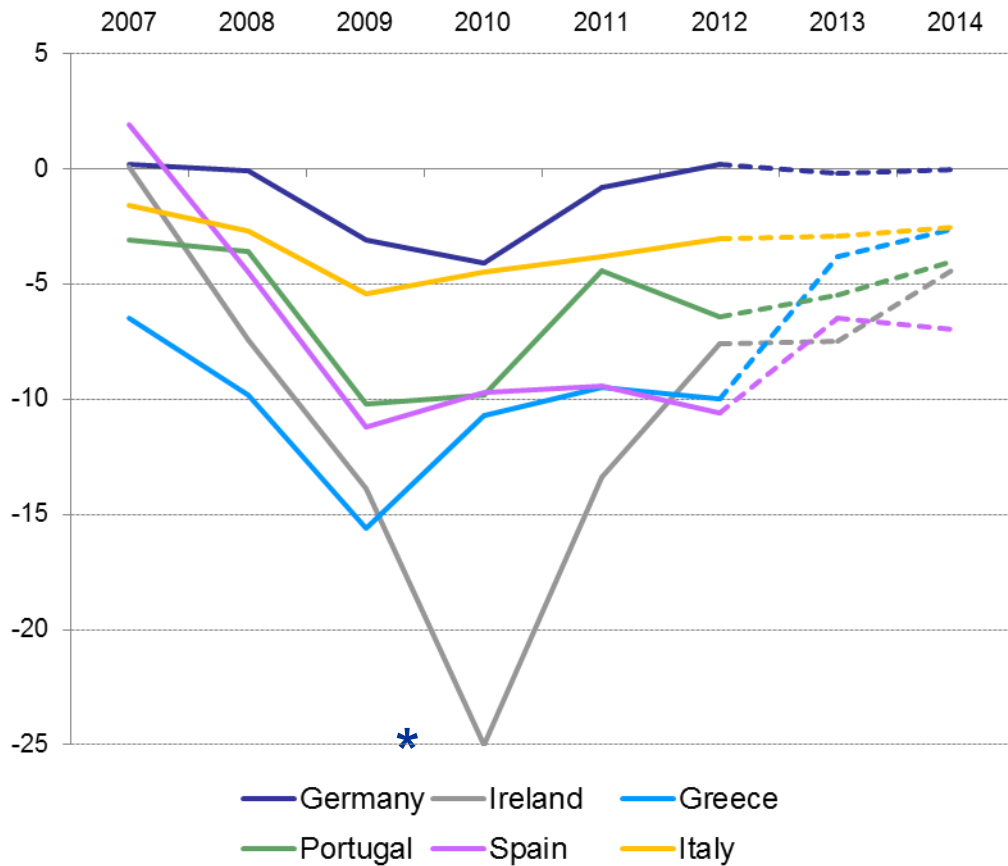


— Germany — Ireland — Greece
— Portugal — Spain — Italy

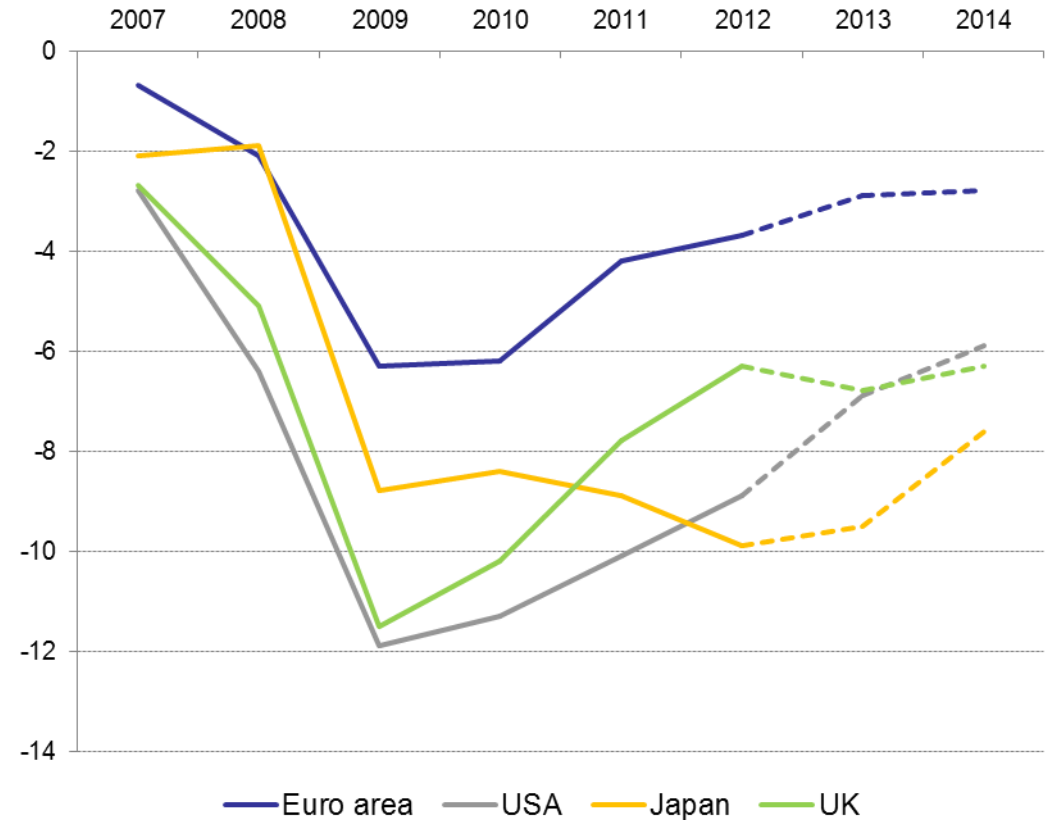
Source: Eurostat,
EC European Economic Forecast - Spring 2013

The strategy is delivering results - fiscal

Fiscal balance, euro area Member States
(as % of GDP)



Fiscal balance, Euro area vs USA and Japan
(as % of GDP)

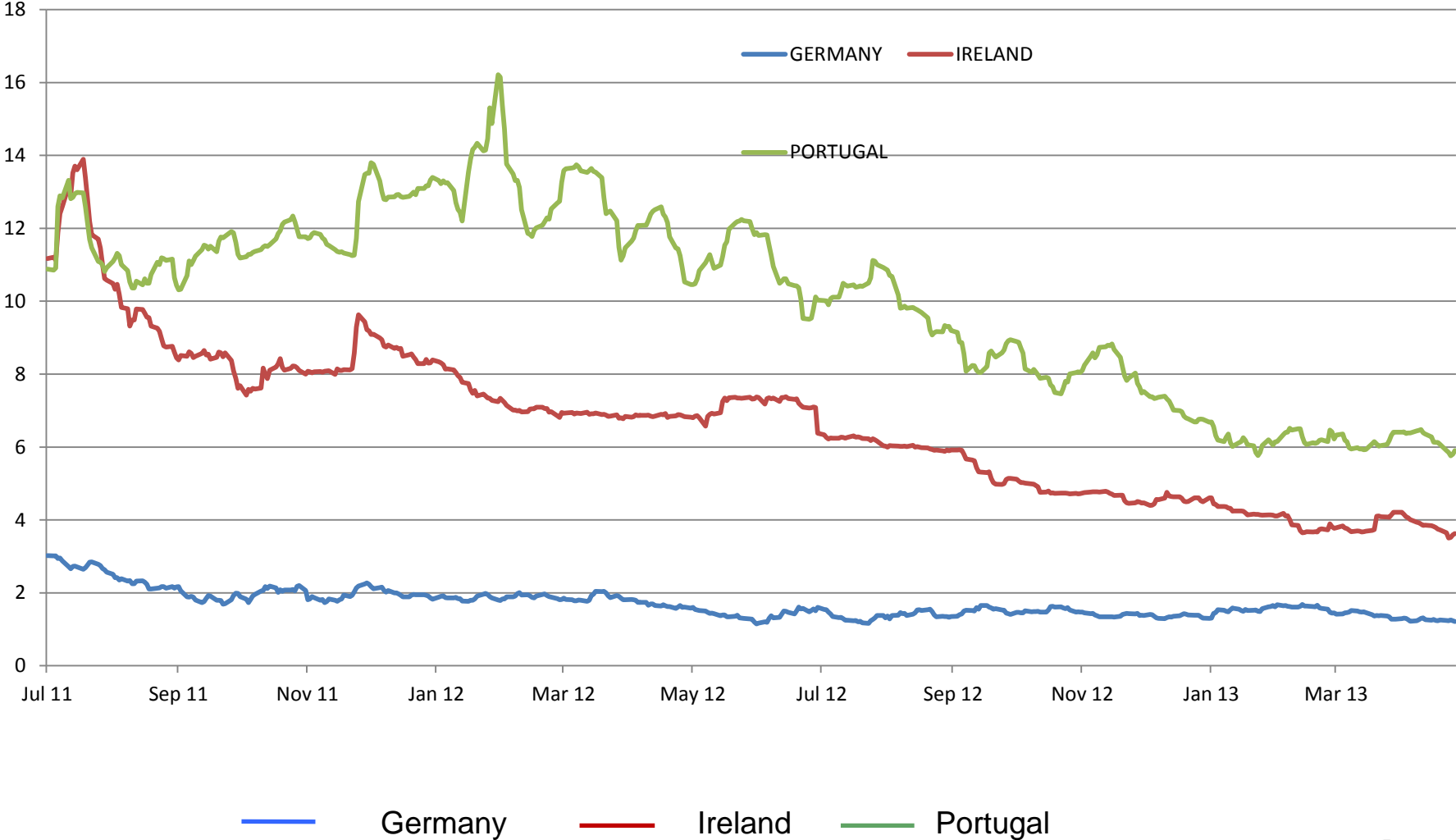


Source: European Commission, European Economic Forecast –Spring 2013

* Actual figure for Ireland 2010 -30.9%

The strategy is convincing the market ...

Long term government bond yields



Source: Bloomberg - 10-year government bond yield, 9-year bond yield for Ireland

... and allowing countries to once again borrow at sustainable rates



Ireland

- successfully regained market access with the issue of a 10-year bond
- Interest rates have fallen considerably



Portugal

- successfully returned to markets with the issue of a 10-year bond
- Interest rates have fallen considerably



Spain

- Maintained access to long-term capital markets
- Remained a regular long-term borrower
- Interest rates have fallen considerably

Improved economic policy coordination in the euro area

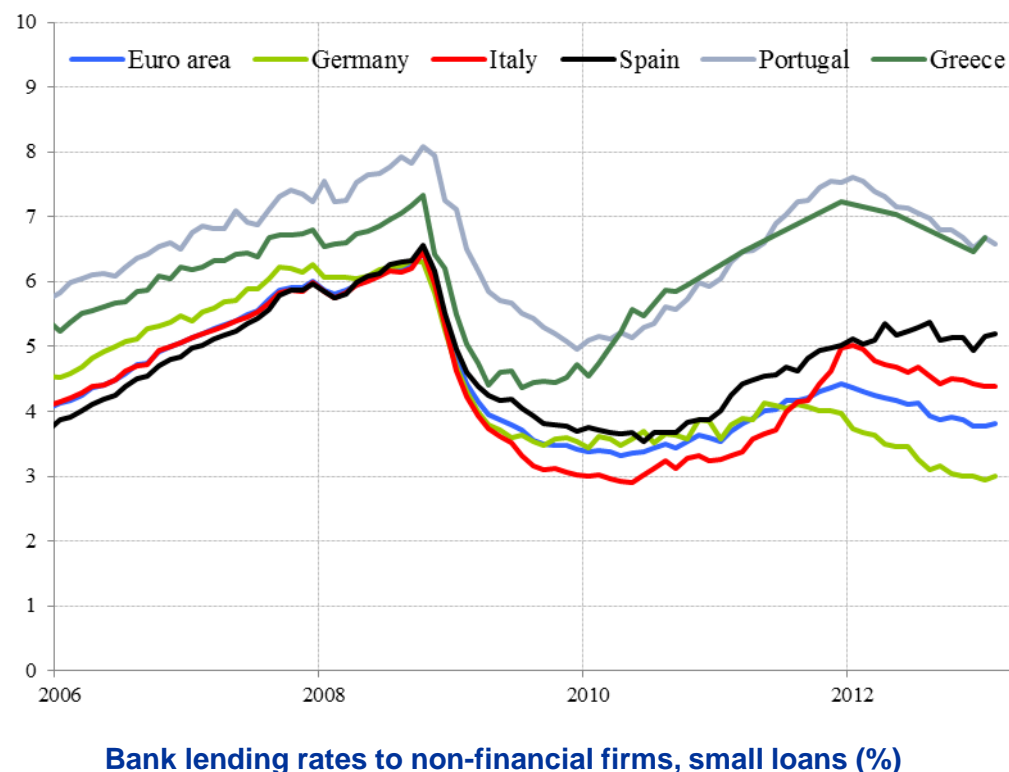
- Euro governments adopted **more comprehensive and binding rules** for economic national policy
 - Stability and Growth Pact has stricter rules on deficit and debt
 - Less room for political interference by the national governments
 - Balanced budget rules are to be introduced in national legal systems
 - Stronger emphasis on avoiding macroeconomic imbalances (eg. excessive public or private debt)
 - Broader Surveillance
 - Much stronger coordination of national economic and budgetary policy
 - New focus: avoid „spillovers“ of bad economic policy from one euro country to another

Reinforcing the banking system

- **Europe is pushing ahead with financial market reforms**
 - “Basel III” to be progressively implemented starting in 2014
- **EU established three new European supervisory authorities – EBA, EIOPA and ESMA**
- **The new ESRB early warning system for identifying and monitoring macro-prudential risks is functioning**
- **EBA decided higher capital requirements for banks – Core Tier 1 capital ratio is raised to 9%**
- **Banks have increased their capital base by over €200 billion in 2012**
 - $\frac{3}{4}$ through fresh capital
 - $\frac{1}{4}$ through decreasing assets
- **Programmes for Ireland, Greece, Portugal and Cyprus contain aid for bank recapitalisation, €41.3 billion has been transferred to Spain to support the banking sector**
- **Problem: renationalization of the capital market in the euro area**

Renationalization of capital market in euro area

- Dispersion of bank lending rates to the non-financial private sector ...
- ... and of overall financing costs for the corporate sector **has increased considerably** across the euro area throughout the recent crisis period



Source: Haver Analytics, ECB
Last observation: Feb. 2013

Banking union

Strong political commitment by Heads of State or Government to set up banking union

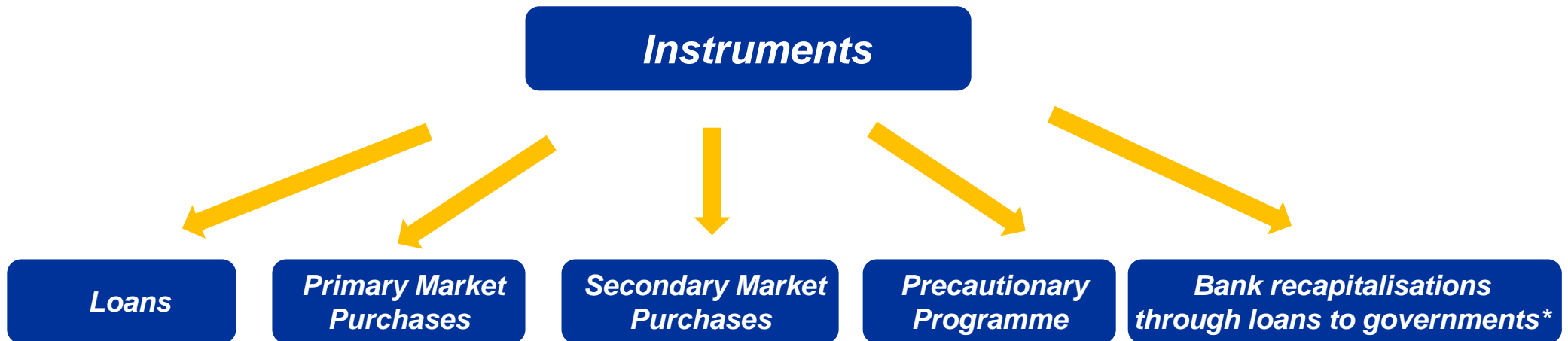
- Single Supervisory Mechanism (SSM) will supervise all systemic banks



- ECB will be responsible for overall functioning of the SSM
- Political discussion on direct bank recapitalization by the ESM is in the final stage
- Bank Resolution Mechanism is currently discussed
- In parallel harmonization of deposit guarantee schemes is prepared
- European Commission will make proposals later this month

EFSF and ESM: mission and scope of activity

Mission : to safeguard financial stability in Europe by providing financial assistance to euro area Member States



All assistance is linked to appropriate conditionality

EFSF and ESM finance their activity by issuing bonds or other debt instruments

* Including in non programme countries

Lending and assistance

■ Support for five countries

- Potential lending capacity: €700bn
- Committed amount to the five countries: €243bn
- Disbursed so far: €200bn
- Macro-economic adjustment programmes for Portugal, Greece, Ireland and Cyprus
- Programme in support of the banking sector in Spain

■ Potential concerted ESM – ECB intervention (Outright Monetary Transaction/OMT)

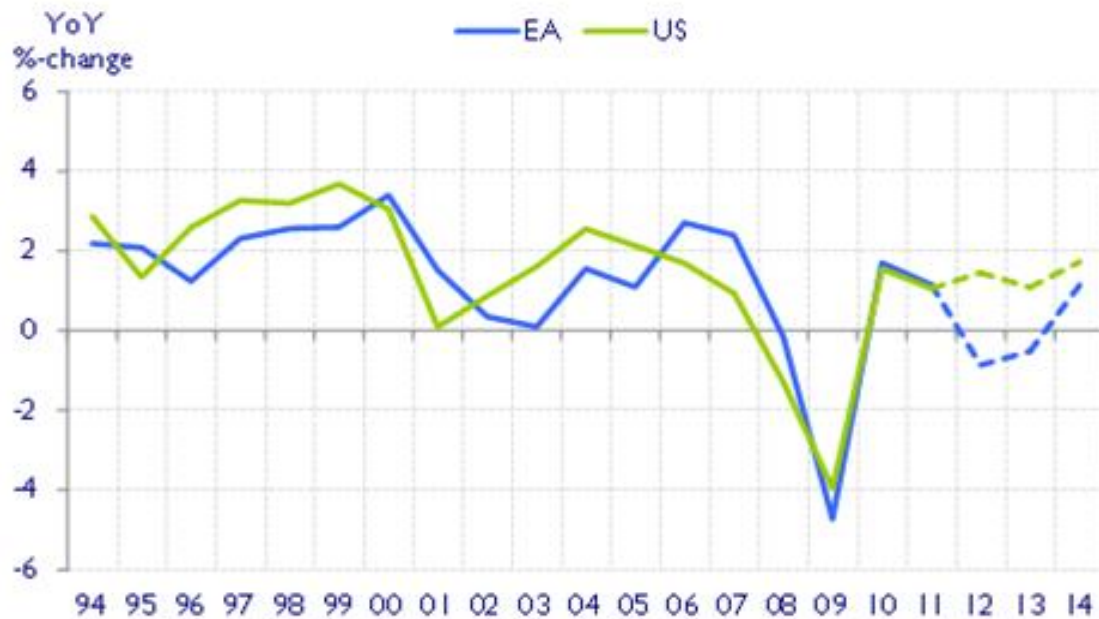
- ESM programme provides conditionality
- The ECB could engage in secondary market purchases.

Measures to boost growth in EU

- **Progress in resolving the euro crisis removes important uncertainties for investors, consumers, banks and financial markets**
- **EFSF/ESM programmes include long list of structural reforms**
- **Coordinated action at national and EU level for Growth and Jobs**
 - Member States take action to achieve specific competitiveness goals
 - Member States coordinate policies to pursue growth-friendly fiscal consolidation and to restore lending to the economy
 - European “Marshall Plan” against youth unemployment
- **European Investment Bank (EIB)**
 - 90% of its lending supports sustainable growth and job creation
 - €10bn capital increase, which will raise lending capacity by €60bn
 - EU-EIB Project Bond Initiative

GDP per capita growth almost identical in the euro area and US

Real GDP per capita growth, annual % change



Average GDP growth per capita, 1994-2011

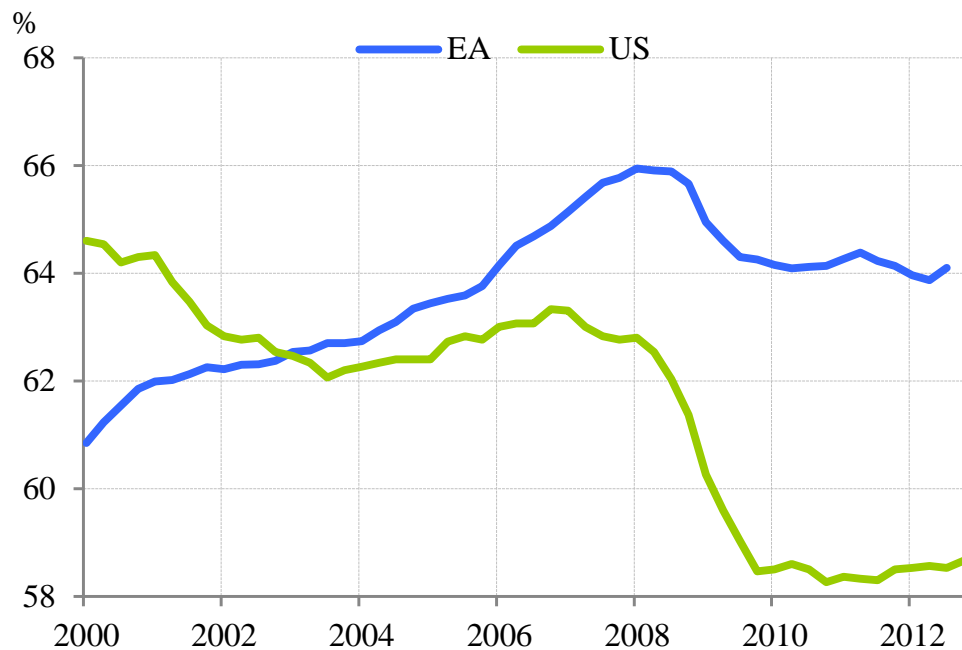
euro area	1.1
US	1.1

Latest observations: Winter 2013 European Commission forecast
Source: European Commission

Labour markets in euro area and US

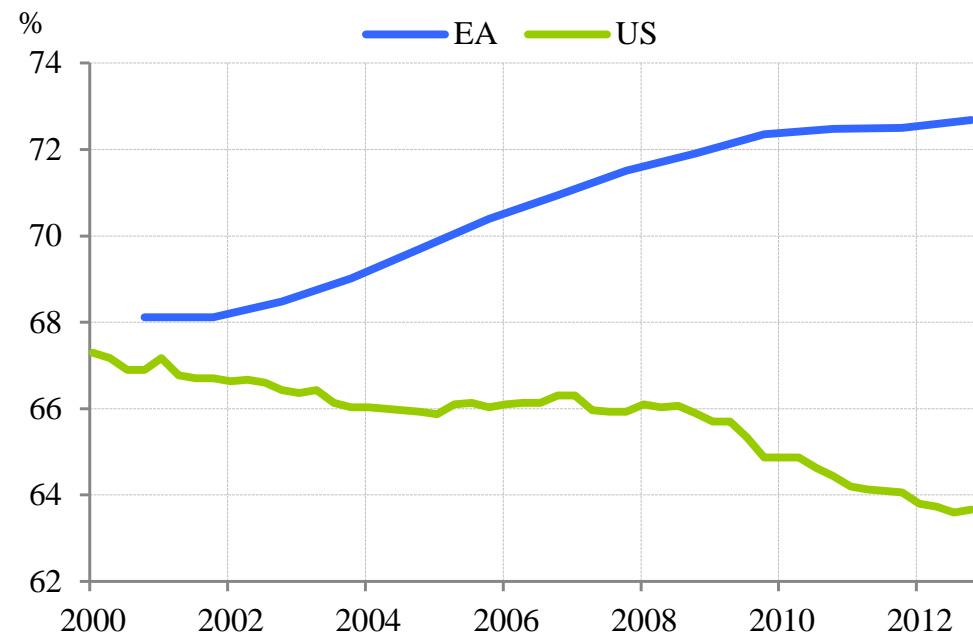
- During the last decade employment has increased strongly in the euro area but fallen in the US
- Participation rate in the euro area today far higher than in the US

Employment rate



Latest observations: Q3 2012 for euro area, Q4 2012 for US
Source: Haver

Participation rate



Latest observations: Q2 2012
Source: Eurostat, Haver

Europe reacts to crisis at national and EU level

- 1) Significant fiscal consolidation and structural reforms at national level
 - Significant progress has been achieved
 - Reforms have to be continued
- 2) Improved economic policy coordination in the euro area
 - Rules and regulations have been significantly improved
 - Rules must now be applied
- 3) Reinforcing the banking system
 - Currently the banking sector is Europe's biggest problem
 - Steps towards a banking union are the appropriate response
- 4) Financial backstops (EFSF and ESM)
 - They are important to accompany the reforms
- 5) Focus now on growth