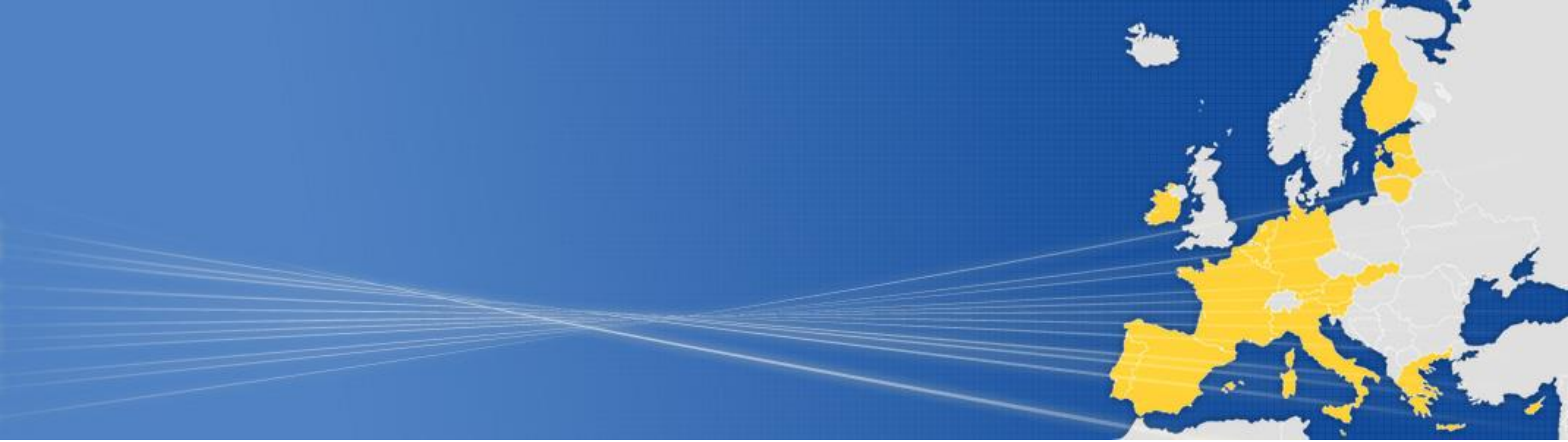


# “What lessons have we learned from the euro crisis?”


## Klaus Regling, Managing Director, ESM


**Peterson Institute for International Economics (PIIE)**

**Washington DC, 15 April 2015**

European Stability Mechanism

# Achievements and missing pieces

## Five lessons from the euro crisis

1. Reduce vulnerabilities, implement reforms
2. Strengthen governance of euro area
3. Create a stronger European banking system
4. An active monetary policy
5. Establish a crisis mechanism

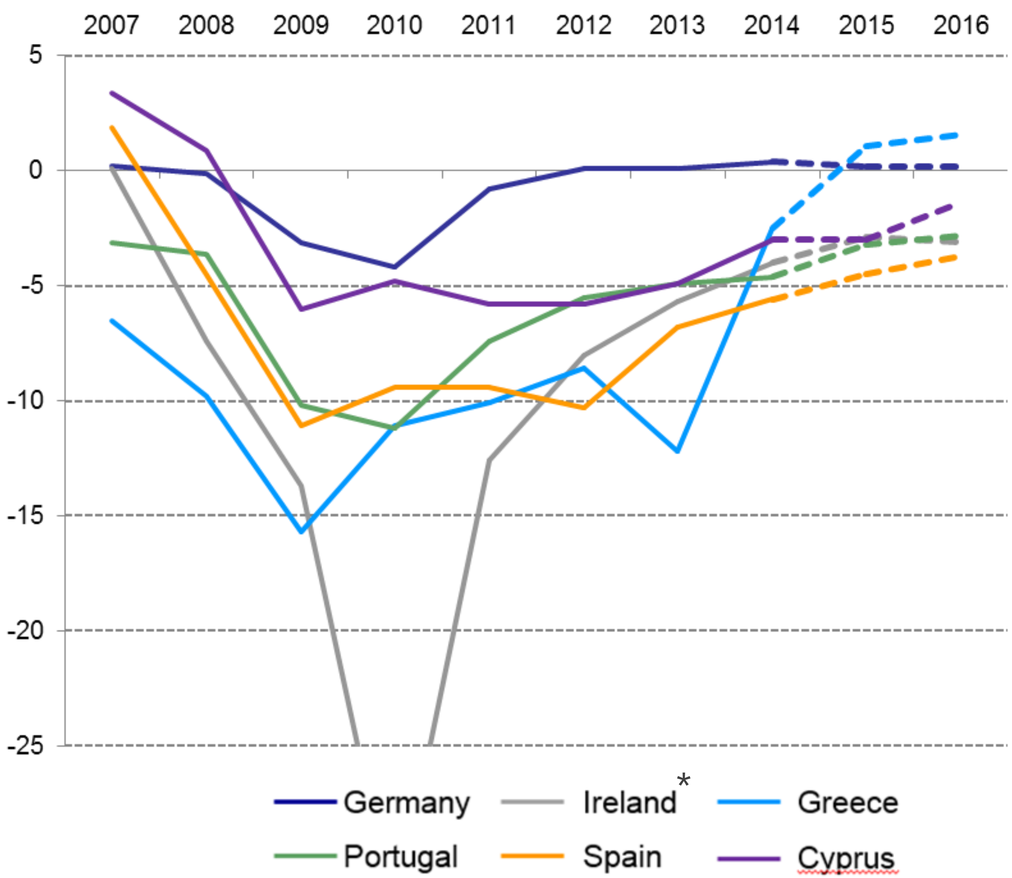
## Further steps to strengthen the resilience of EMU

1. Improve governance further
2. More risk sharing
3. Complete Banking Union
4. Envisage treaty changes

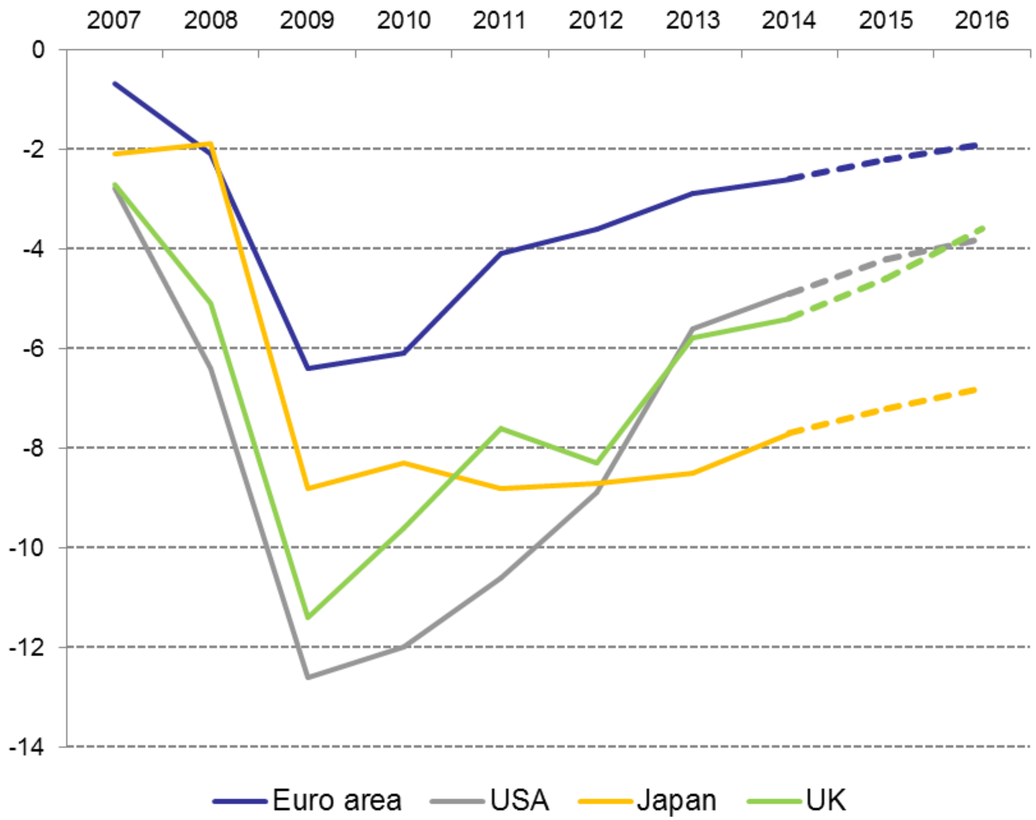
# 1. Reduce vulnerabilities, implement reforms

# Deficit reduction policies are paying off

## Fiscal balance in programme countries (% of GDP)




## Selected comparative fiscal balances (% of GDP)




Source: European Commission, Economic Forecast – Winter 2015

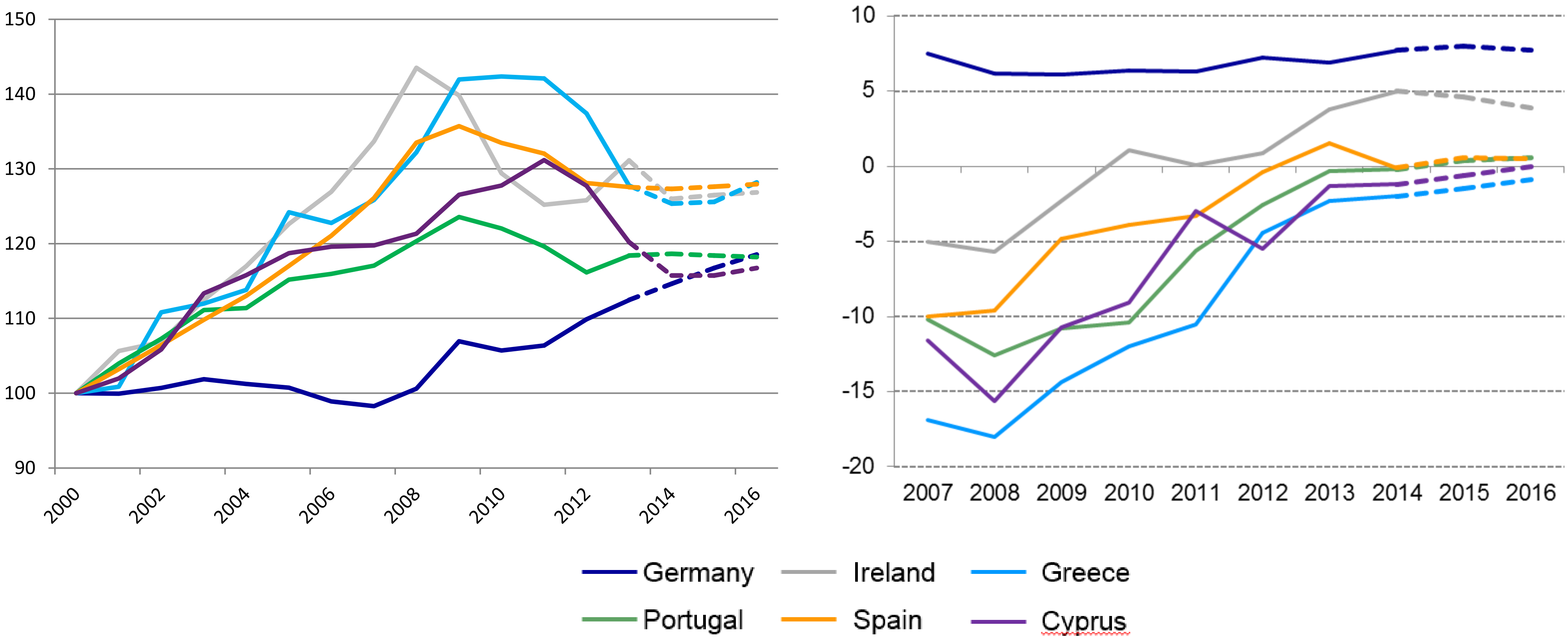
* Actual figure for Ireland in 2010: -32.4%

# Internal devaluations are restoring competitiveness

- Thanks to the convergence in competitiveness, unsustainable external imbalances in the periphery have corrected

Nominal unit labour costs (2000=100)

Current account balance (% of GDP)




Source: EC European Economic Forecast – Winter 2015

# EFSF/ESM programme countries are the reform champions

- **Greece, Ireland, Portugal and Spain** are in top 5 of 34 **OECD countries** with regard to implementation of **structural reforms.**

| Ranking in OECD report |
|---|
| 1. **Greece** |
| 2. **Ireland** |
| 3. Estonia |
| 4. **Portugal** |
| 5. **Spain** |

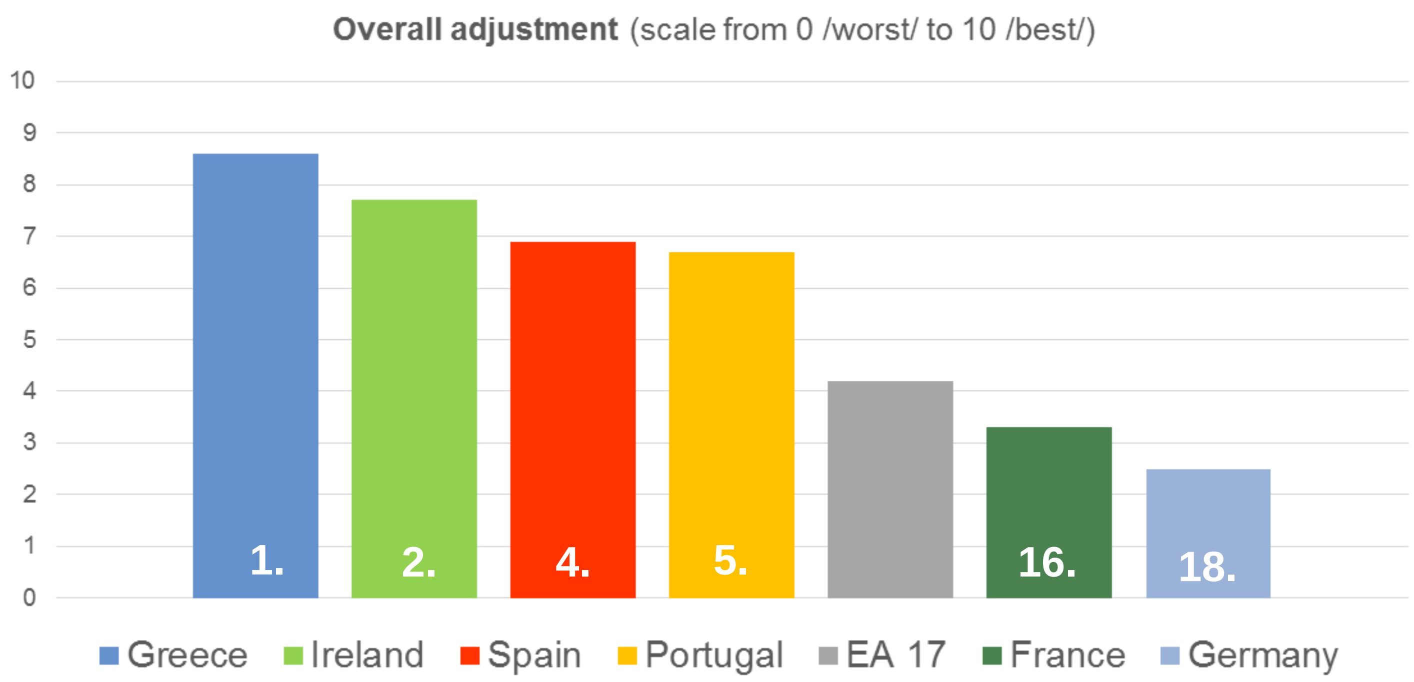
*"Euro area countries under financial assistance programmes are among the OECD countries whose responsiveness* [to the OECD's structural reform recommendations] *was highest and also where it most increased compared with previous period."*

*- Going for Growth* (OECD Report)

Source: OECD report *Going for Growth* for 2015
Ranking takes into account responsiveness to OECD recommendations on structural reforms in key policy areas

# EFSF/ESM programme countries are the reform champions (2)

- **Lisbon Council: Greece, Ireland, Spain and Portugal** ranked highest in overall measure of 4 key medium-term adjustment criteria:
  - Rise in exports
  - Reduction of fiscal deficit
  - Changes in unit labour costs
  - Progress in structural reforms

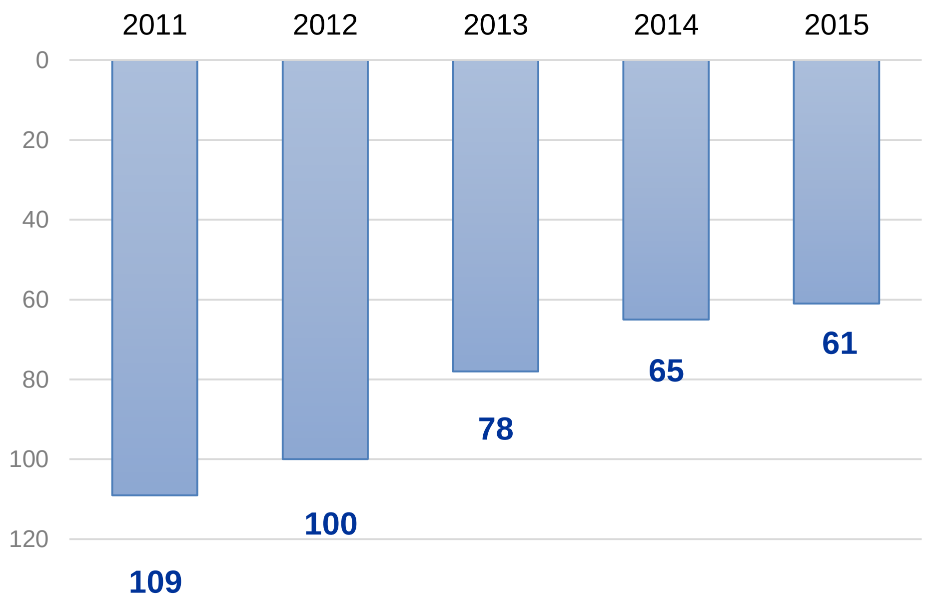



Source: “Adjustment Progress Indicator” in *2014 Euro Plus Monitor* published by the Lisbon Council

The ranking comprised 17 euro area countries + UK, Poland and Sweden

# Greece has improved business regulations

- Greece has advanced from position **109** to **61** in the **World Bank's *Doing Business*** ranking
- The ranking measures the ease of starting and operating a local business




**Greece's ranking in World Bank's *Doing Business survey***

Source: the World Bank

# 2. Strengthen governance of euro area

# Improved economic policy coordination

- Euro governments adopted **more comprehensive and binding rules** for national economic policies
  - **Stability and Growth Pact** has stricter rules on deficit and debt
  - **Less room for political interference** by national governments
  - **Balanced budget and debt rules** now also in national legal systems
  - **European Semester**: yearly cycle of economic policy coordination
  - Annual **country-specific recommendations**
  - Stronger emphasis on **avoiding macroeconomic imbalances**
  - **Eurostat** authorised to verify national data

# 3. Create a stronger European banking system

# A stronger banking system

- **Three new European supervisory authorities: EBA, EIOPA and ESMA**
- New **ESRB** monitors macro-prudential risks
- **Financial market reforms**
  - “Basel III” (CRDIV/CRR) is being progressively implemented
  - Huge capital increase for banks – Core Tier 1 capital ratios are now 9% or more
  - EU banks added €560 bn to their capital since 2008
- **Banking Union** started in November 2014
  - **Single Supervisory Mechanism** (SSM) operational since 4 November 2014
  - **Bank Recovery and Resolution Directive** (BRRD) will create a uniform framework for bank recovery at national level with **bail-in** as a key instrument
  - **Single Resolution Mechanism** (SRM) with **Single Resolution Fund** (SRF)
  - **ESM Direct Recapitalisation Instrument** available



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esm

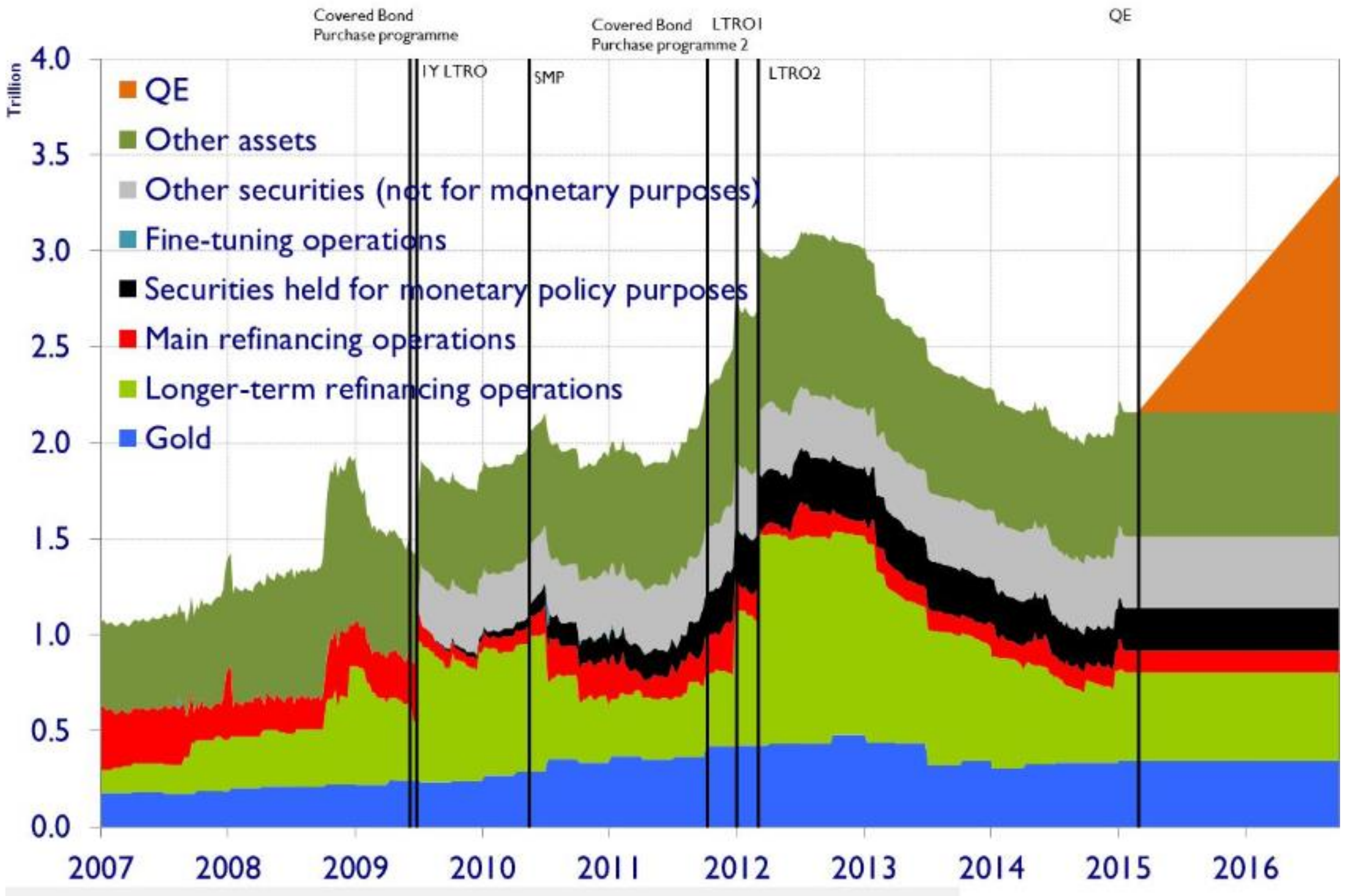
# 4. Monetary policy in crisis

# Monetary policy in a crisis

- **SMP**: from 2010 to 2012, ECB purchased euro area sovereign bonds (over €200 billion) in secondary markets
- **LTRO** gave banks unlimited liquidity: in December 2011 and March 2012, around **€1 trillion** allotted in 3-year loans
- **OMT** announcement in September 2012 calmed the markets
- **New package** in June 2014
  - Targeted LTRO (at least €400 billion available lending capacity) designed to stimulate lending to small- and medium-sized companies
  - Negative deposit rate
- Programme for buying ABS and covered bonds announced in September 2014
- **Quantitative Easing** programme announced in January 2015
  - Asset purchases expanded to include euro area government bonds
  - Combined monthly purchases of €60 billion from March 2015 to September 2016

# QE asset purchases by the ECB started in March 2015

## The ECB's balance sheet is to reach €3.4 trillion in Sept. 2016






European Stability Mechanism

# 5. Establish a crisis mechanism

# EFSF and ESM: mission and scope of activity

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

***Instruments***

- ***Loans***
- ***Primary Market Purchases***
- ***Secondary Market Purchases***
- ***Precautionary Programme***
- ***Bank recapitalisations through loans to governments***
- ***Direct bank recapitalisation*** (European Stability Mechanism esm only)

**All assistance is linked to appropriate conditionality**

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

# EFSF and ESM lending

- **Support for five countries (EFSF: Ireland, Portugal, Greece; ESM: Spain and Cyprus)**
  - Combined lending capacity: €700 bn
  - Committed amount to the five countries: €238.6 bn
  - Disbursed so far: €232.5 bn
  - EFSF/ESM disbursed three times as much in Europe as IMF in same period globally
  - Ireland, Spain and Portugal have exited their programmes
  - Macroeconomic adjustment programmes for Greece and Cyprus ongoing

# Benefits of EFSF/ESM lending

1. All Member States have **remained in the euro area**
2. EFSF/ESM programmes promote **fiscal adjustment** and **structural reforms**
3. EFSF/ESM lending supports **return to debt sustainability**
4. The euro area has a **lender-of-last-resort** for sovereigns

# Benefits of EFSF/ESM lending

## Loans are euro area solidarity

### Potential savings of EFSF/ESM financing vs theoretical market cost (for 2013)

| | In € billion | As percentage of GDP | As percentage of total primary expenditures |
|---|---|---|---|
| **Cyprus** | 0.24 | 1.5 | 3.4 |
| **Greece** | 8.58 | 4.7 | 8.6 |
| **Ireland** | 0.68 | 0.4 | 1.1 |
| **Spain** | 2.43 | 0.2 | 0.6 |
| **Portugal** | 1.27 | 0.8 | 1.7 |

*Calculated using theoretical market spread of 5- and 7-year bond of each country matching the EFSF/ESM maturity profile on the 3 months before and after each country requested support. This is compared with the equivalent EFSF/ESM funding cost.*

# 1. Improve governance further

# Why euro area governance needs to be strengthened?

- Rules-based approach has become too complicated
- Even specialists find it difficult to understand EU fiscal and budgetary framework
- Therefore: transition from rules to joint-decision making and common institutions
- Incomplete EMU holds back investment, growth and employment

# How can goverance be strengthened?

- Additional steps in euro area integration likely
- **Proposals under discussion:**
  - a euro area finance minister
  - a “fiscal capacity” for the euro area
  - joint decision-making for structural reforms
  - more democratic accountability and legitimacy
- Implementation legally and politically difficult and time-consuming
- But **enhanced cooperation** within the EU Treaty or **intergovernmental agreements among** 19 euro area members would allow for more integration

# 2. More risk sharing

# Risk sharing options

- **Already substantial risk sharing:** EFSF, ESM, EIB, SRF, elements of monetary policy, TARGET

Additional ideas that do not require changes to the EU Treaty:

- "**Rainy day fund**" – a buffer or buffers accumulated during good times
- **Common system of minimum unemployment benefits** or system to finance when unemployment rises above „normal“ levels
- **Targeted fiscal capacity** to reward structural reforms
- More risk-sharing **through financial markets**

These options can be implemented **without permanent transfers and debt mutualisation** among euro area Member States

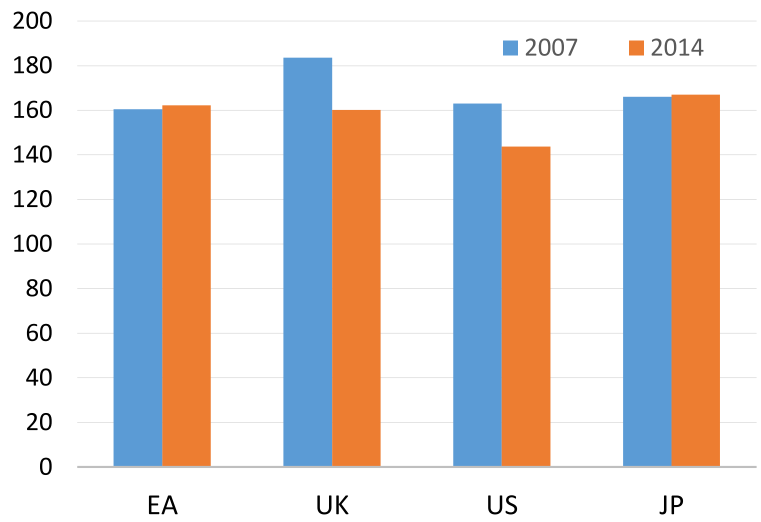
# 3. Complete Banking Union

# Complete Banking Union

- Develop capital markets union
- Single Resolution Fund  (SRF) will be gradually mutualised and built up to reach target level of €55 bn  by 2024
- Backstop for SRF to be developed
- Harmonisation and consolidation of Deposit Guarantee Schemes
- Promote private sector deleveraging in Europe

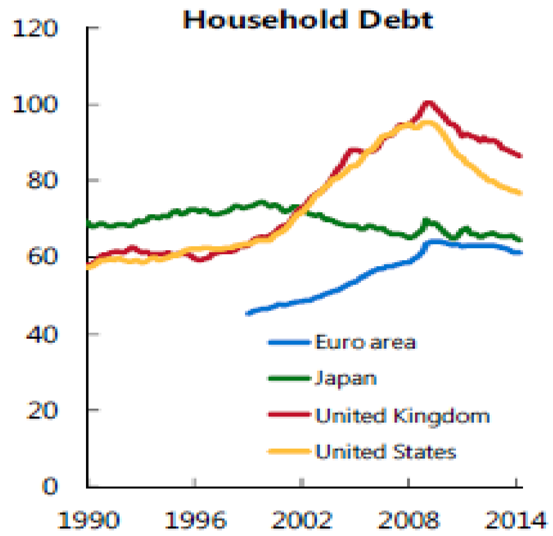
# Private sector deleveraging

- Euro area needs to reduce private sector debt, in line with US and other advanced economies
- This applies mainly to corporate debt, as household debt is lower in euro area than in US




Total private sector debt (non-financial) as % of GDP in 2007 and 2014

Source: BIS, IMF




Household debt/GDP (%) in major advanced economies (gross figures)

Source: IMF Global Financial Stability Report 2015

# 4. Envisage treaty changes

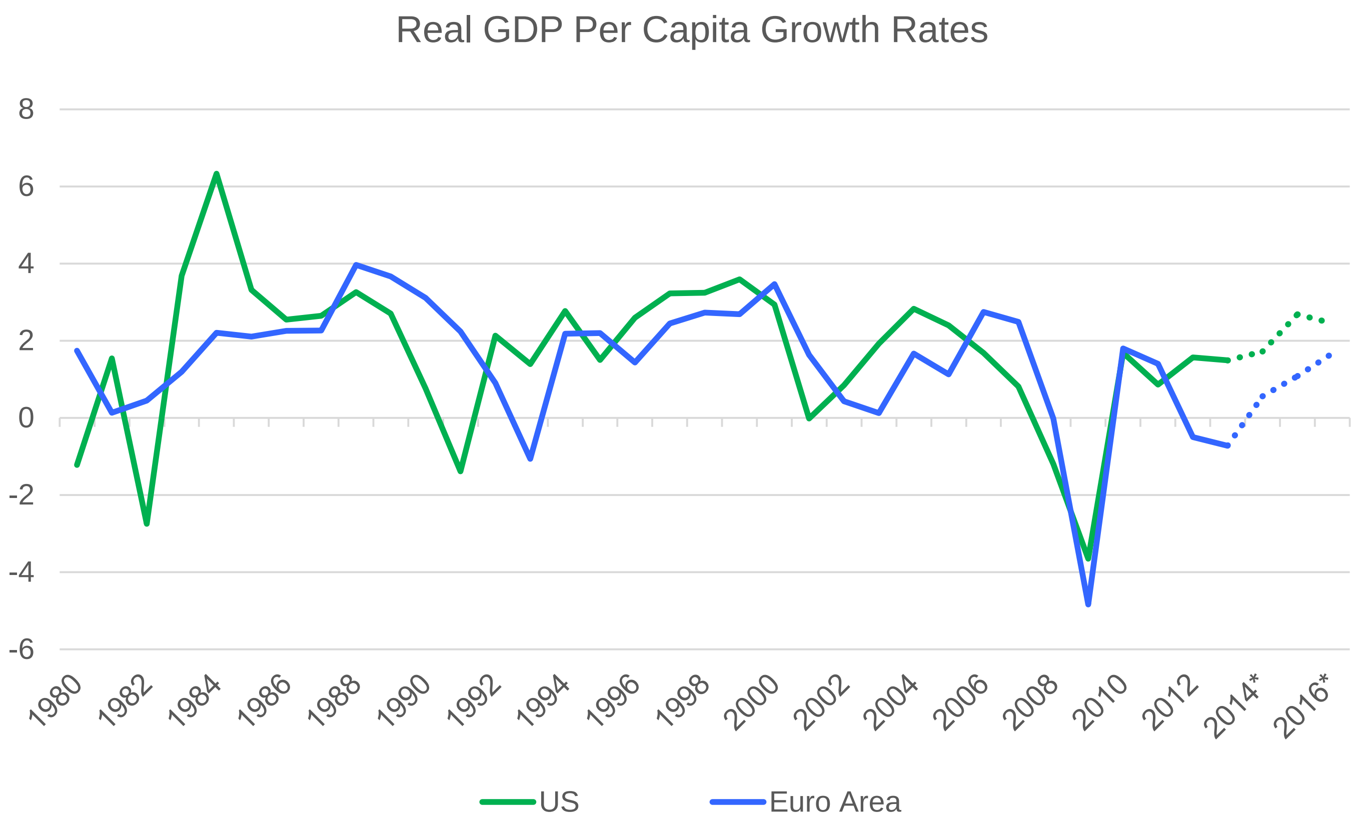
# Possibilities with EU treaty changes

- **Options for EU treaty change**
  - Incorporate intergovernmental agreements into treaty
  - Give the Commission the central political role in Europe
  - Separate out tasks such as Competition decisions
  - Separate euro area bank supervision from the ECB

# Annex

# GDP per capita growth comparison

## GDP/capita growth since 1980 has been very similar in US and EU




**Average GDP growth per capita, 1980-2010**

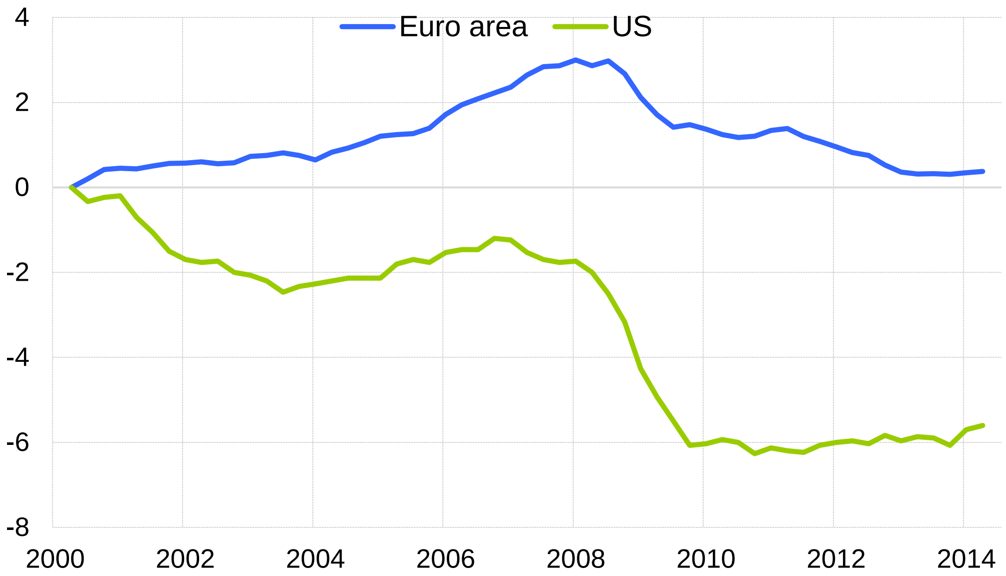
| US | EA |
|---|---|
| 1.68 | 1.60 |

Source: Ameco and ESM calculations

# Labour markets

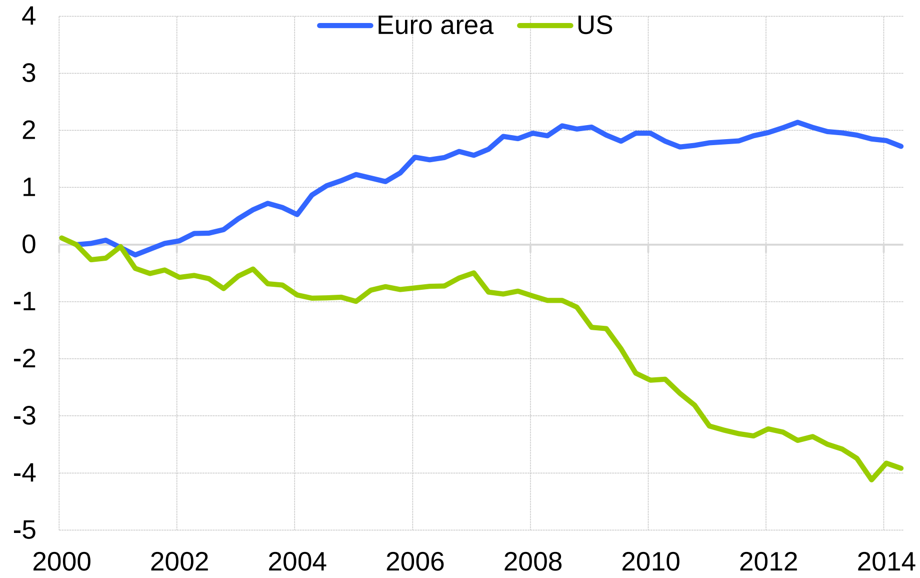
- Since 2000, employment rate has increased in euro area but fallen by around 6 p.p. in the US
- Participation rate in euro area stabilised after rise until 2009; in US continues to decline

**Employment rate change since 2000 (%)**




Age group: 15+ for euro area, 16+ for US
Latest observations: Q2 2014
Source: Eurostat and BLS

**Participation rate change since 2000 (%)**




Age group: 15+ for euro area, 16+ for US
Latest observations: Q2 2014
Source: Eurostat, BLS and ESM



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