How to complete the European monetary union? - speech by Klaus Regling

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Speeches

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Good afternoon,

I am just back from a meeting with a small group of students. We talked about ways going forward to create a more perfect economic and monetary union (EMU).

For me, such small get-togethers as well as this bigger event now, are important. It is not sufficient to attend the Eurogroup meetings, the monthly meetings of the 19 euro area finance ministers. Your views on the world and the state of the economy, your ideas and perceptions, and criticisms do matter. And I would like to encourage you to voice your opinion, now and in the future.

I am happy to be here today. The reputation of the London School of Economics (LSE) goes well beyond the EU. Several of my colleagues at the ESM are former LSE students. And who knows, maybe one day I will have the pleasure to welcome some of you at the ESM.

What can you expect in the next quarter of an hour? I will summarise the state and the likely future of the monetary union and highlight the role of the ESM as part of deepening the EMU. I will outline what has happened during the last years in the euro area, where we are now and what is missing to complete monetary union.

The mandate of the institution I manage – the ESM – is to safeguard the financial stability of the euro area. The euro, like Europe, has survived crises and storms despite what has been said. 10 years ago many people in the market, in the media, and academics – also here at the LSE – were sceptical about the prospects of the monetary union. Many market commentators predicted the end of the euro.

What has happened?

What was the reason behind such gloomy predictions? Let us go back in time to 2008: the euro area experienced two major economic and financial crises in the past decade. First, we had to deal with the global financial crisis. Although it originated in the U.S., it affected Europe as well as other parts of the world. And then, Europe was hit by a second crisis, the homemade “euro crisis”.

How did we overcome the crisis? The crisis response at European and national level was comprehensive, and had four components that were all essential. First, through deep and difficult reforms in the Member States that received financial support; second, through the unconventional monetary policy of the European Central Bank (ECB).

Third, through a stricter and broader coordination of economic policy at European level. And fourthly, the institutional architecture of EMU has been significantly strengthened. With the beginning of banking union, the Single Supervisory Mechanism (SSM) and Single Resolution Board (SRB) were created, establishing banking supervision and resolution at the European level. Last but not least, with the establishment of the rescue funds, the temporary EFSF and permanent ESM, a gap in the architecture of EMU was closed.

The ESM was not part of the initial set-up of EMU. There was no “lender of last resort for countries” in the euro area. The ECB is “only” the lender of last resort for banks. The reason is simple: it was not imaginable that a euro area country could lose access to market financing and find itself on the brink of default. To be fair, nobody expected a crisis like the one we had eight to ten years ago – the worst economic crisis in Europe in 80 years.

The ESM has established itself as a permanent institution with sufficient firepower. 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.

But unlike the IMF, which gets the money for its programmes from central banks, we issue bonds on the markets. The ESM has therefore some unique features: as it issues bonds to fund its loans, it is in contact with investors all-round the world and is thus able to gauge the opinion of investors in the euro and to collect market data on an ongoing basis.

During the last eight years, both rescue funds disbursed about €300 billion to five countries: Ireland, Greece, Spain, Cyprus, and Portugal. This provided essential financing to governments, without which some of the countries would probably have been forced to leave the euro area.

Countries benefit from budgetary savings because our loans have 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.

Where we are now?

Today, the euro area is better equipped to deal with a future crisis than ten years ago. We have no significant macroeconomic imbalances in the euro area, we have new institutions, the ECB has additional instruments, we have broader policy coordination, and we have enjoyed several years of growth in the euro area. In terms of GDP per capita, growth in the euro area is again broadly similar to per-capita growth in the US.

On the financial side, work on risk-reduction has noticeably brought down the levels of banks' non-performing loans (NPLs). This paves the way for more risk-sharing in the euro area. I will get to this in a moment.

What is missing to complete monetary union?

Today we see that the euro area came out of the crisis much stronger, but some challenges remain. It makes sense to take a few additional steps to make EMU even less vulnerable before the next crisis hits. Enhancing the role of the ESM is part of these reforms.

What does this imply? With the reform, the ESM will be more involved in the design, negotiation and monitoring of future programmes. We will do this together with the European Commission. The ESM will also act as a backstop to the Single Resolution Fund (SRF). If the SRF resources are depleted, the ESM can lend the necessary funds to finance a bank resolution.

In addition, the ESM's precautionary credit lines will be made more effective to prevent small issues becoming big problems.

I expect that a final agreement on the ESM Treaty is reached in the next few months, so that the ratification process can start then. That will take about a year.

What are the other remaining steps needed to make the euro area fully crisis-proof in the future?

In my view, decisions in four areas are required:

First, **a common deposit insurance**. 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 in the last ten years, all ESM programmes could have been substantially smaller. Obviously, legacy problems in the balance sheets of some banks need to be sorted out before a common deposit insurance becomes possible.

The second issue to be resolved is **liquidity in resolution**. The completion of banking union also requires addressing the remaining risks of a liquidity gap after a resolution. Different proposals to address the possible liquidity shortfall are currently being discussed.

Third, a **fiscal capacity for macroeconomic stabilisation** is needed. This is a very controversial topic among the Member States of the euro area. But in my view this is a key element missing in the architecture of our EMU. A fiscal capacity would be useful because countries that are members of a monetary union have given up two key macroeconomic policy instruments: monetary policy and exchange rate policy. Moreover, a common monetary policy can often be pro-cyclical for individual countries.

There are several proposals on the table. From the European Commission, the IMF but also from Germany’s finance minister Olaf Scholz who proposed a reinsurance of national unemployment insurance. The ESM published a paper, which shows that a rainy day fund without additional transfers can be created. Rainy day funds, for instance, pay out during a crisis, but states reimburse the money when they recover. I am sure you will find this paper interesting – you can find all references of my speech on the ESM website – and perhaps you may want to bring your own contribution to this debate.

Progress in these three areas and in creating a capital markets union would improve risk-sharing within the monetary union significantly. That can be done without creating permanent transfers and would really help to avoid small problems from becoming big problems where an ESM programme would be needed. I want to avoid that.

Finally, we should begin to think about a **European safe asset**, even though this is highly controversial. A safe asset would increase the volume of highly rated assets, which is now limited to a few sovereign and supranational issuers, and is actually shrinking in the euro area. It would provide a common benchmark that is needed to price debt throughout the euro area. A safe asset would also allow Europe’s banks to reduce their holdings of national debt, and to attract international capital to Europe. Safe assets would be a crucial step to integrate financial markets, and to make the euro more attractive for international investors, thus strengthening the international role of the euro.

Conclusion

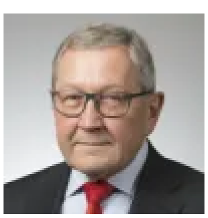
I can conclude that the euro area is stronger and more resilient today than it was ten years ago. The process of deepening EMU further is continuing and will lead to a broader mandate for the ESM.

In addition, I hope we will see progress in the four areas I mentioned, even if that takes a number of years. That would continue the process of deepening monetary union. And it would certainly strengthen the role of the euro in the international monetary system.

Thank you.

References:
ESM (2018), A case for a European rainy day fund

Author



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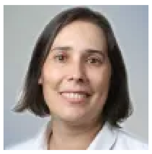

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