The Future of Europe’s Monetary Union - speech by Klaus Regling

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Good morning,

Recently I came across this quote: “The European Union is the best answer to the great challenges of our time – challenges, which individual countries can no longer master alone.” It is from Angela Merkel’s Laureate speech at the Charlemagne Prize Ceremony in 2008. Well before the global financial crisis, before the euro crisis and before Covid-19.

Where do we stand now?

Within weeks, a regional health crisis transformed into a pandemic and economic activity in most countries in the world came to a standstill. To contain the virus, the EU’s four fundamental freedoms – free movement of goods, capital, services, and labour – came to a halt for first time in recent memory.

As the pandemic spread, economies became more and more affected. And as a result, the euro area is facing its most severe recession ever recorded.

The economy has contracted far more than during the global financial crisis ten years ago. Forecasts expect a decline in growth of 9-12% in 2020 and a GDP rebound of 3 ½-6% next year.

For the last few months, Europe’s economy has been operating at a fraction of its capacity. Supply chains and production lines have been disrupted, the trade in goods and services collapsed, and household spending and private investment shrunk to historic lows.

The challenge we are facing right now, relates to the nature of the crisis: it is multi-dimensional – it affects the economy but more importantly it affects lives of many people. At the same time, this crisis is symmetric, hitting all member states. But the impact on the economy is asymmetric across both countries and sectors.

The pace and magnitude of the recovery will not be equal for all, with divergences across households, sectors and countries. During the recovery, we should make sure that we balance these divergences as much as possible.

While all EU member states support their workers and companies, not all can do this to the same extent. This creates the risk of an unbalanced recovery, which could lead to economic fragmentation, distortions in the EU’s single market and divergences in the monetary union.

To prevent that, a strong and concerted European response is underway. It is in the interests of all EU member states to support such collective action.

Governments and European institutions moved fast to mitigate the immediate effects of Covid-19 with a number of crucial measures that are already in place.

Immediate action against Covid-19

In March, the European Commission activated the General Escape Clause, temporarily suspending the EU fiscal deficit rules of the Stability and Growth Pact.

The Commission also provided increased flexibility in the implementation of state aid rules. This enabled almost €2 trillion worth of national rescue schemes to be implemented during the pandemic.

The ECB reacted swiftly by significantly expanding its asset purchase programme with the Pandemic Emergency Purchase Programme – first by €750 billion, then by another €600 billion in early June.

This purchase programme has acted as a stabilising force for financial markets and sovereign spreads, thus containing fragmentation in the euro area.

The ECB also took action to ease the burden on the banking sector and to keep credit flowing – by relaxing collateral requirements, and allowing for more flexible use of banks' capital and liquidity buffers.

EU's pandemic support package underway

In April, the euro area finance ministers decided on a first support package with three safety nets: one for sovereigns provided by the ESM, one for businesses provided by the EIB and one for workers provided by the EU Commission.

These safety nets can immediately provide up to €540 billion.

The ESM was set up to help overcome crises. You will discuss this further today in the panel discussion "10 years of saving Europe", moderated by ESM Chief Economist Rolf Strauch.

For the current crisis, the ESM will provide a credit line, the Pandemic Crisis Support, to finance direct and indirect healthcare costs related to the viral outbreak.

Euro area countries are eligible to receive an amount equal to 2% of their GDP in loans, which would imply a total of around €240 billion if all 19 countries applied. Of course, we do not expect that all euro area countries will request the new facilities but perhaps one third.

Since mid-May, countries can draw on this credit line, financed by issuing social bonds. My colleague Siegfried Ruhl, Head of Funding and Investor Relations, will explain this in detail later in the panel discussion “Response to Covid-19: the impact for funding”, moderated by my colleague Sarah Fouqueray-Carrick, who leads the ESM’s Investor Relations team.

Additionally, the European Investment Bank will create the second element of the package: a pan-European guarantee fund of €25 billion. It will allow the EIB to provide an additional €200 billion in loans to companies in the EU. The guarantee fund would complement and enhance national programmes that provide liquidity support.

And the European Commission has created a lending instrument designed to support short-time work schemes and similar measures to help member states protect jobs, employees and self-employed against the risk of dismissal and loss of income. The programme is called SURE and it will provide up to €100 billion to EU member states.

National efforts to fight Covid-19

In addition to the efforts at EU level, all countries undertook swift and extensive policy actions. In the euro area, the total volume of these national measures amounts to 36% of GDP – if one adds up discretionary fiscal measures, automatic stabilisers and guarantees.

This is a fiscal policy response of unprecedented proportions and bigger than during the Great Depression in the early 30s, putting national public finances under strain.

For the euro area as a whole, the deficit is expected to rise to 10% of GDP this year, from ½% in 2019. This is the largest 1-year increase in history.

The national measures and the safety nets I just described helped address the most urgent, short-term needs. Without these measures, the economic damage this year would be even bigger. But as we enter the recovery phase; we have to ensure that the recovery is sustainable, even, inclusive and fair for all member states.

Getting ready for the recovery phase

In May, German Chancellor Angela Merkel and French President Emmanuel Macron announced a joint proposal for an EU recovery fund. To reiterate their commitment to support the EU recovery, both leaders met this Monday in Meseberg.

According to the Franco-German initiative, the European Commission would raise €500 billion by selling bonds and distributing the funds as grants to EU countries and sectors hardest hit by the virus. The debt would be repaid out of the future EU budget.

The European Commission took up the main elements of this proposal when it unveiled its proposed recovery fund at the end of May. This new instrument, also known as “Next Generation EU”, aims to help EU countries’ economies to recover.

If fully implemented, it will boost the EU budget with new financing raised during 2021-2024. To finance this €750 billion package, the Commission will borrow money on financial markets on behalf of the EU, through the issuance of bonds. €500 billion would come in grants and €250 billion in loans.

“Next Generation EU” requires the approval of all 27 EU member states. Heads of State and Government will meet again mid-July to find an agreement.

Although I agree that the recovery fund is the most pressing need now and EU leaders will be focusing on that, once agreement is reached, we should return to the discussion we had before the pandemic: how to strengthen monetary union.

Future steps for a complete monetary union

We need additional steps to deepen the monetary union, which would make it more robust. These include the ESM reform, the completion of banking union, a capital markets union and a fiscal capacity for macroeconomic stabilisation.

With the reform, the ESM will be more involved in future stability support programmes. We will do this together with the European Commission.

The ESM will also act as a backstop to the Single Resolution Fund. If the SRF resources are depleted, the ESM can lend the necessary funds to finance a bank resolution.

In addition, the ESM has reviewed its precautionary credit lines and made them more effective.

Last December, the Eurogroup agreed in principle on the ESM reform. The final sign-off is still missing. It is, however, the precondition for national ratification procedures to start, which I assume will take at least a year.

As long as the ESM reform is not ratified, the banking union cannot be completed because the backstop to the SRF is an essential element and one of the immediate steps to advance the completion of banking union. We should not waste this opportunity. We need to complete banking union and make progress on the capital markets union. I will not go into the details because the next panel will do that.

But I want to put banking union and capital markets union in the context of deepening the Economic and Monetary Union. The euro area needs more economic cross-border risk-sharing. This is underdeveloped between euro area countries, compared to United States, for example. More cross-border banking in Europe would be one way to increase risk-sharing through the private sector. More integrated capital markets that facilitate cross-border investment flows would be another way. That is one important reason why it is so important to complete banking union, and to put the capital markets union in place.

In addition, research suggests that increasing the depth and liquidity of euro area financial markets, and strengthening the credit quality and liquidity of euro area debt, would also support the international role of the euro.

Both – banking union and capital markets union –reinforce each other, and support the deepening and completion of monetary union.

The EU remains fragmented in 27 individual capital markets, with cross-border finance constrained. This lack of an EU capital markets union weakens Europe’s businesses and households. According to the capital markets union High Level Forum, the European banking system “is not sufficient by itself to provide the amount of credit the EU economy will need to recover from the crisis”. Without stronger market financing, economic growth will remain subdued.

The ESM supports these findings of the High Level Forum chaired by Thomas Wieser.

Another step for deepening the Economic and Monetary Union, should be a fiscal capacity for macroeconomic stabilisation. 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 monetary union. 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.

Finally, we should think more about a European safe asset. A safe asset would allow Europe’s banks to reduce their holdings of national debt, and to attract international capital to Europe.

With the current support package, the three safety nets I mentioned earlier and the recovery plan, which is under negotiation, we will increase the already existing €800 billion volume of European debt significantly: the supply of safe assets issued by European institutions could increase to almost €2 trillion. Together with sovereign debt of member states rated AA+ or above, this could add up to about 40% of euro area GDP, still relatively small compared with the U.S. with nearly 90%.

A broader and deeper market of safe assets would be a crucial step to integrate financial markets, and to make the euro more attractive for international investors, strengthening the international role of the euro.

Let me close here.

Conclusion

Many European countries are gradually easing their lockdowns, cautiously returning to some sort of normality – even if it will take a while before our economies are back

to the pre-crisis level.
Europe as a whole has indeed responded to this unexpected crisis rapidly and in a concerted way and has truly shown that “The EU is the best answer to the challenges of our time”.

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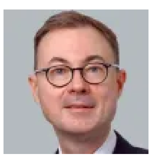

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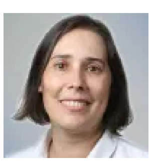

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