Reforming the ESM: Implications for European financial stability and resilience - speech by Klaus Regling

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03/02/2021
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Keynote address "Reforming the ESM: Implications for European financial stability and resilience"

Institute of International and European Affairs (IIEA) webinar

Online, 3 February 2021

(*please check against delivery*)

IIEA · Klaus Regling - Reforming the ESM – Implications for European Financial Stability and Resilience

Good afternoon.

It’s a pleasure to meet you all virtually. Under normal circumstances, I would have enjoyed coming to your beautiful city of Dublin as I haven’t been there in a while, but unfortunately that isn’t possible yet. So I am speaking to you from Luxembourg today, where the ESM is based.

I was asked to speak about the ESM’s new enlarged mandate and its implications for financial stability and resilience. However, I would first like to recap how the role of the ESM has evolved over the past ten years. It is useful to understand where we came from before we discuss where the ESM reform will take us.

Origins of the crisis funds

Prior to setting up the ESM as a permanent institution in 2012, euro area countries established a temporary facility, the EFSF, in 2010. The EFSF provided loans to Ireland, Portugal and Greece. The ESM, its successor, did so for Spain, Cyprus and

Greece. The total amount disbursed by both institutions to the five countries was €295 billion.

Ireland was the first country to benefit from our support in 2011. We disbursed almost €18 billion to Ireland between 2011 and 2013 as part of a total support package of over €67 billion. When the Irish economy came out of the programme, it was stronger and more competitive than before. In fact, when I talk about the ESM and what we do, I often refer to Ireland as one of our biggest success stories.

The Irish government immediately took full ownership of the necessary measures and this is one of the reasons why Ireland managed to complete the bailout programme so quickly and so successfully.

That is not to say that everything went smoothly or that it did not require any sacrifices, far from it. Budget cuts and structural reforms are always very painful and nobody likes to have salaries and pensions cut by 20 to 30 percent. However, these harsh measures paid off when competitiveness was restored and Ireland speedily regained market access after the crisis.

Ireland has since made good progress in repaying some of the debt it accrued during the bailout, even paying back its IMF loans early. This is another clear sign of how strongly the economy rebounded after the financial crisis. And although the debt-to-GDP ratio will now increase temporarily due to the extra funding needed to fight the pandemic, we expect debt levels to start decreasing again in the medium term.

Indeed, a lot has happened in the last 10 years. Looking back, we can now confidently say that the national and EU responses to both the global financial crisis and the subsequent euro debt crisis were comprehensive and effective.

The EU’s response to the Coronavirus pandemic

Let me now turn to the situation we are in today. The measures we took ten years ago are now proving very useful as they provided us with a stronger institutional framework and improved tools to deal with the current crisis.

At the same time, it is important to note that we are in a very different context today compared to the financial crisis. This time, we do not need to correct past policy mistakes or macro-economic imbalances in the euro area. Instead, we are responding to a common external shock for which governments are not responsible.

So, unlike past ESM programmes, there are no conditionality clauses this time. Conditionality makes sense when policy mistakes and macroeconomic imbalances need to be corrected. That was the case from 2010 to 2018, conditionality was necessary at the time and it worked. EFSF and ESM loans with conditionality helped five countries to regain market access and to achieve an above-average economic performance afterwards.

The current situation does not require such a conditional approach. Today, the EU's only condition for its two loan-based safety nets introduced in the pandemic – the ESM's Pandemic Crisis Support for countries and the European Commission's SURE instrument for workers – is that countries have to use the funds to address the consequences of the pandemic.

More specifically, the ESM loans are earmarked for covering direct or indirect healthcare costs. The ESM offers all euro area countries a precautionary credit line of up to two percent of their GDP. This is a significant amount. If all 19 euro area members were to request it, which I do not expect, the total amount of loans would add up to €240 billion.

Although no country has requested this credit line yet, its mere existence has calmed markets. Countries can still request the Pandemic Crisis Support until the end of 2022. It is also worth noting that these loans will be financed by issuing social bonds for the first time. This is part of the EU's efforts to make Europe greener and more digital.

The ESM's pandemic support credit line is part of a larger package of €540 billion to support workers, businesses and member states. While the ESM supports countries, the European Investment Bank supports companies and the European Commission supports workers with its SURE programme.

In addition, there is the extraordinary €750 billion 'Next Generation EU' recovery fund, which aims to boost investments and reforms in all EU countries to mitigate the impact of the pandemic on economic growth. And let's not forget the European Central Bank's monetary policy programmes that continue to stabilise markets.

Taken together, these measures will not only help each and every EU country to fight the pandemic, they will also protect the single market and the cohesion of the euro area. This degree of EU solidarity is unprecedented and once again shows that Europe is committed to remaining united. Together, we are stronger.

An enlarged mandate for the ESM

But although we have taken extensive measures to fight the current pandemic, there is more work to be done. We should continue to deepen our Economic and Monetary Union (EMU). While we took important steps in the past decade with the creation of the ESM and banking union, we should now complete this process to make the EMU more resilient.

This brings me to the ESM reform, which will enlarge the mandate of the institution I manage. This reform is another important step towards deepening our monetary union and making it more resilient to shocks.

Before we take a closer look at the changes the reform entails, I would like to point out that Paschal Donohoe, who became President of the Eurogroup in July 2020, was instrumental in reaching a final agreement on this reform. He is also the Chairperson of the ESM Board of Governors, which is our top policy-making body, so we work together very closely. The reform was agreed upon by all 19 euro area finance ministers but it will only enter into force after ratification by all national parliaments, a process which is scheduled for completion this year.

While the ESM reform aims to further deepen EMU and brings us closer to completing banking union, some of the proposed measures will also prove particularly useful in mitigating the economic and financial fall-out from the Coronavirus pandemic.

So let’s take a closer look at what the ESM reform aims to achieve.

First, the ESM will put in place an additional instrument to support bank resolution, introducing the so-called common backstop to the Single Resolution Fund. The Single Resolution Fund is the EU body that takes care of the resolution of failing banks. If the fund does not have enough money to resolve a bank, the ESM can lend it that money.

All the money the ESM lends the Single Resolution Fund as a backstop will be repaid with contributions from the banking sector within three to five years. In other words, governments will not have to bail out large banks at the expense of taxpayers, the contributions to the Single Resolution Fund and the ESM backstop will come from the banking sector itself.

When the backstop will take effect in 2022, it will not just be another key element of the banking union but it will also contribute to the robustness and resilience of the EMU as a whole.

Although banks are generally in a better position today than during the euro crisis, some banks might face problems in the future. However, the banking sector’s profitability was already subdued prior to the pandemic and we can expect further pressure on bank profitability as impairments increase and the economic fallout of the pandemic fully materialises. Many banks across Europe will likely face challenges as we transition out of the pandemic. Nevertheless, a strong and well-financed resolution mechanism will reduce the risk of disorderly bank resolutions, which will in turn reassure and stabilise markets.

The **second** part of the ESM reform strengthens the preventive and precautionary features of the ESM toolkit. The Coronavirus pandemic shows that an external shock can come out of the blue anytime, so it is important to enable institutions to put appropriate financial facilities in place quickly.

As we can see in the current crisis, precautionary credit lines like our Pandemic Crisis Support can reassure markets even when not drawn upon. Sometimes it’s enough to know that you have an insurance even when you don’t intend to use it.

Once the reform has been implemented, it will be easier for countries to access these credit lines without extensive negotiations about policy conditionality when certain requirements are met.

The **third** part of the reform foresees that the ESM will strengthen its cooperation with the European Commission and will have an enhanced role in designing, negotiating, and monitoring future euro area stability support programmes. You may recall that the country support programmes were managed by the so-called troika of the European Commission, the European Central Bank and the International Monetary Fund in the past. Going forward, the troika will no longer exist. Instead, programmes will be managed jointly by the European Commission and the ESM. This change in governance for future programmes will enable a more coherent, streamlined and rapid crisis response.

Both institutions will collaborate in accordance with their respective roles and mandates. The European Commission is in charge of policy coordination and will guarantee that EU provisions are always respected. At the same time, the ESM will ensure that public resources are well spent and that a borrowing country is able to repay the loans.

So to sum up, the ESM reform will introduce a backstop to the Single Resolution Fund, it will strengthen our toolkit and it will give the ESM a larger mandate in designing and monitoring support programmes for countries. All this will strengthen our ability to prevent and resolve crises and the reform should also help to make the euro area as a whole more stable and resilient to future shocks.

Further deepening EMU is key

This brings me to the broader topic of deepening economic and monetary integration. While we have made considerable progress on strengthening EMU over the past ten years, we are still missing a few important elements.

The introduction of the backstop brings us closer to the completion of banking union. However, we are still missing a common deposit guarantee scheme. This would be a valuable tool to ensure the stability of the banking system and would be a step towards completing banking union.

In addition, a better integration of capital markets through the creation of a capital markets union is necessary to facilitate cross-border investments, increase risk-sharing and open up new ways of financing for companies. This in turn would improve the allocation of capital in the euro area and make the euro more attractive to international investors.

Another element which is needed to strengthen EMU is a fiscal capacity for macroeconomic stabilisation in the euro area. This would allow for more risk-sharing between countries. The new Resilience and Recovery Facility, which will be financed by bonds issued by the European Commission, is such a tool, and hence it will result in additional fiscal risk sharing. However, it is not a permanent facility, and it is geared towards structural reforms in the wake of the pandemic. I believe a permanent facility for euro countries only, in the form of a revolving fund instead of a budget, would be useful. It would give countries more fiscal space in a downturn than is currently the case.

Finally, the need for more euro-denominated safe assets is increasingly recognised. The bonds issued by the European Commission to support the economic recovery after the pandemic will significantly increase the volume of safe European bonds. If these bonds are added to the existing bonds issued by the ESM and the European Investment Bank, plus bonds issued by highly rated sovereigns, this total pool of European safe assets will roughly correspond to 40% of the GDP of the euro area. While this is certainly a large increase in this ratio, it is still only half the comparable ratio for US dollar safe assets. In other words, the total volume of euro-denominated safe assets remains comparatively low despite the recent increases.

Concluding remarks

To conclude, I would like to reiterate that we have come a long way since the financial crisis. Macroeconomic imbalances have been corrected and countries in need of financial support, such as Ireland, have not only regained market access but also had a very positive economic performance until the pandemic hit. Going forward, we have a clear agenda for really completing EMU: first, we need full banking union and progress towards capital markets union. Second, we need a fiscal capacity for macro-economic stabilisation. And third, we need more European safe assets. These measures would not only make the euro area more resilient to future shocks, they would also strengthen the international role of the euro.

With that, I have finished my introduction. I would be delighted to hear your views and answer any questions you may have.

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