Speech at Global Implications of Europe's Redesign conference

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05/10/2016
Speeches
ESM
New York, United States

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“Lessons Learnt From the Crisis”

Global Implications of Europe’s Redesign conference, New York, 5 October 2016

(*Please check against delivery*)

Ladies and gentlemen,

It is a real pleasure for me to be here with you in this great city. Whenever I’m in New York, I enjoy the energy of the place. New York is a city with many nicknames, and I read that New Yorkers sometimes call it “the Centre of the Universe”. So some might say modesty isn’t New York’s strongest point. But when you walk around Manhattan, you can understand why.

The institution that I am heading is based in that other Centre of the Universe – Luxembourg City. Only a hundred thousand people live there. But while Luxembourg is small, Europe – which it is part of – is not. Like New York, there is no need for Europe to be modest. And yet we sometimes are. We are when replying to our critics, particularly those in the Anglo-Saxon world. And we are when faced with pessimism about our future, which persists many years after the crisis. So let me tell you about some of the successes we've had in fighting the euro crisis, and about the tremendous progress we have made since then. Let me give you some reasons why Europe is worth investing in, and a good place to do business with.

Since the calamitous events of World War II, Europe has been on a steady path towards unification. The first step was taken 1952, when six countries established the European Coal and Steel Community. This was followed by the European Economic Community in 1958, the European Union in 1993, and the euro in 1999. From six countries more than 60 years ago, 28 independent nations have now pooled parts of their sovereignty. In this light, while we have to respect the UK vote to leave the EU, it is still a step in the wrong direction. However, I do not think that other countries will follow its example. The UK has always been a bit of an outlier in the EU.

European unification has brought immeasurable benefits. The continent has lived through 70 years of peace, something never seen before in the history of Europe. The EU also offered the countries emerging from communist rule a realistic perspective on economic transition, an opportunity they have used well.

In 1999, 19 countries went one step further, and adopted a common currency and monetary policy. This shows a huge political will that is without comparison anywhere else in the world.

The euro is often described as a purely political project, but that is not correct. The economic benefits from the single currency are huge. At the heart of Europe's integrated architecture is the single market, which guarantees the free movement of people, goods, services and capital. This has brought great stability to Europe, and materially raised the standards of living for citizens.
The euro makes the single market work better. It enables countries to enjoy its full economic benefits. Companies now no longer pay foreign exchange costs – of some €20 to 25 billion per year. Cross-border trade between euro area countries has received a boost of up to 10%, as companies do business in a much larger home market. Transaction costs have fallen sharply. Price transparency has increased, so consumers can make better choices. This has led to greater competition, which, as we know from economic theory, results in larger productivity gains, and thus higher growth.

What is perhaps less well known is that the single currency has solved a serious problem of monetary policy in Europe. Before the euro, Bundesbank decisions dictated monetary conditions in many countries outside Germany. Yet because of its mandate, the Bundesbank could only take the economic situation in Germany into account when setting monetary policy. This often led to suboptimal monetary conditions in other European countries. It is quite similar to what we see globally nowadays, where emerging markets like India and Mexico are heavily influenced by the monetary policy of the Fed. By law, the Fed cannot take this into account, at least not directly. With the advent of the euro, this problem no longer exists in Europe. The ECB looks at the whole of the euro zone when deciding its policy stance - a big advantage for the economies that use the euro. I mention this because some well-known academics – particularly in this country – continue to recommend that we should give up the euro. They say monetary conditions are not appropriate for individual countries, as they are based on the economic situation in the entire area. But they forget that the situation was worse before the introduction of the euro.

And, by the way, the situation was not only difficult for smaller European countries unable to influence decisions of the Buba. Quite often, it was also difficult for Germany, which suffered repeatedly from currency turmoil inside Europe. The last time was in 1995, when – triggered by the Mexican Tequila crisis - the Deutschmark appreciated massively against other European currencies (+20% against the Italian lira, for instance). German exports suffered, which cost Germany one percentage point of growth that year.

The EU - and monetary union in particular - are therefore extremely valuable political and economic undertakings. We need to continue to improve them where necessary. I’d like to give you some ideas on how this can be done. But first, let me remind you of what Europe has achieved in the last few years since the crisis began.

Europe had to deal with a double crisis. First, starting in 2008, banks and the economy were hit by the subprime crisis, which started in the United States, but quickly spread through the global financial system. This was then followed by the euro debt crisis at the start of this decade, which was of Europe’s own making.

Years of irresponsible fiscal policies had caused unsustainable budget deficits and debt burdens in several countries. Others had become uncompetitive, pricing themselves out of international markets with misguided wage policies. Housing bubbles contributed to the imbalances, endangering the banking system when they burst.

Soon, risk premia for countries such as Greece and Ireland became prohibitively expensive. When the EMU was set up, it had been deemed unthinkable that a euro zone country could lose market access. But that is exactly what was now happening - and there was no mechanism to cope with it. Many predicted the euro would break up. And it is true, that if we had not taken action, some countries would have needed to leave. But the euro is still here, thanks to the decisive action that was taken.

Firstly, countries did their homework. They put their fiscal house in order, and adjusted macroeconomic policies. Budget gaps have now tightened to more sustainable levels across the euro zone and are below the United States in the aggregate. Equally important, competitiveness has returned, and current account imbalances have largely disappeared. On top of these national efforts, the European Commission has also been given greater powers to monitor countries and discipline them when they break the rules.

The two institutions I manage are the European Stability Mechanism, and its predecessor the EFSF. Together, they are filling a gap in the European institutional framework. We are a lender of last resort to sovereigns, a function that did not exist before the crisis. The two institutions have provided assistance to five countries: Greece, Ireland, Portugal, Spain and Cyprus. We have a total of €246 billion in loans outstanding, three times as much as the IMF’s €81 billion. Our loans are a form of financial solidarity between euro zone countries, given that they constitute substantial budgetary savings for programme countries. This is because our lending rates are very favourable: only one-third of what the IMF charges. And obviously well below what a country in distress would pay in the market. We have calculated that this saves the Greek budget €8 billion each year, or 4.5% of GDP. And yet, this comes at no cost to the euro zone taxpayers. We fund ourselves in markets by issuing bonds and bills. The reason that we can do this so cheaply is because of our strong credit rating which is based - in the case of the ESM – on the €80 billion in capital euro zone countries have paid in.

To summarize, the crisis has caused the process of European integration to accelerate considerably. Within a timespan of six years, Europe has come out of the crisis stronger than it was before. The fact that we have shown we can deal with a crisis, should give us the confidence we can also tackle the next. It also helps to explain why support for the single currency remains high. Across the euro zone, two-thirds of the people support it, and a majority of the people in practically each country are in favour. This support is impressive in a time of rising populism and a general aversion against globalization. It gives politicians the mandate to proceed with the necessary reforms to strengthen EMU.

What also helps, is that the European economy is doing fairly well. There is often a pessimist perception that it isn't, but that is a superficial view, and the facts don't confirm it. Growth in Europe is above potential, so the output gap is closing. It is true that potential output growth is disappointingly low. But in per-capita terms, economic growth in Europe is similar again to that in the US, just like it was for decades until 2009. It's an important indicator, because it measures the average rise in standards of living, taking out differences in population growth. What's more: benefits from growth are spread more equally in Europe than in America. In Europe, 80 percent of the population has seen real income growth in the last 15 to 20 years. In the US, that was the case for only 10 to 20 percent. Last but not least, participation and employment rates in Europe are higher today than in the year 2000. That means that a higher percentage of the population actually has a job today compared to 15 years ago, despite the high unemployment rate. In the US, the participation rate has decreased significantly.

I do not deny that Europe is also facing major challenges. I already mentioned the low potential growth rate. There is not a single obvious solution for this issue, but any package of policy measures will need to include the promotion of more investment in the economy. In that light, the European Commission's Investment Plan is an important initiative, as it aims to mobilise investments of at least €315 billion in three years. You will have a chance to discuss this in the session this afternoon.

Another challenge is related to our banks. I certainly see no general crisis around the corner, even though individual banks may face problems. But it is true that US banks in the aggregate have higher leverage ratios, and are more profitable. This latter point is because they have written off non-performing loans more aggressively than European banks, so less capital is tied up.

The good news is that the bad loans are well provisioned. Banks are much safer because they have raised more than €600 billion in capital since the crisis. In banking supervision, our progress since the crisis has been unprecedented, and we have taken some steps that would have been unthinkable only a few years ago. The euro zone now has a single prudential supervisor for systemically important banks, the Single Supervisory Mechanism. Countries have transferred powers that were once with national supervisors to the EMU level. Secondly, we set up the Single Resolution Board, a supra-national rescue authority for any euro zone bank that is in trouble. Now that we have these two institutions, prudential regulation in Europe is roughly comparable to the set-up in the United States.

Now, the UK vote to leave the European Union is certainly a setback. The UK has always been somewhat of an outlier in the EU, so I see little risk of other countries following its lead. But Brexit still forces us to think hard on what caused it, and what lessons to draw. Populism is on the rise all over the world – not just in Europe. Brexit is another example of this trend, of this push-back against globalisation, free trade and international cooperation and therefore not surprisingly against the EU. For economists, it is hard to understand this rejection of globalisation. We know the ample historic evidence that free trade raises living standards. One lesson for us as economists, politicians and bankers is that we haven't worked hard enough to explain this. The second is to acknowledge that not everybody in society is a winner from globalization. We have not always listened well enough to those unable to adapt to the disruptions free trade can bring.

Brexit has made clear that now is not the time for an unqualified call for more Europe. We need to be smarter about European integration. In policy areas with clear advantages– such as monetary union or protecting our common external borders – we need more cooperation. But we also need to accept that some problems in Europe can better be solved at a national or regional level. Handing these back to a level closer to citizens will improve accountability and democratic control, and therefore support for the EU.

I want to emphasise that - with all the steps taken during the last six years - monetary union today works better than before the crisis. We do not need a full political union nor a full fiscal union to make the euro a success. If we did, monetary union would be a country – and that is not on the cards for the foreseeable future.

Still, there are some important next steps to make monetary union more robust. These steps fall under the heading of risk-sharing between countries. Risk-sharing refers to the mechanisms by which a shock – positive or negative - to one country's economy is shared by others that surround it. Risk-sharing helps smooth the business cycle in these countries, making their economies more resilient.

Risk-sharing can take place in two ways: through financial markets and the fiscal channel. Both are underdeveloped in the euro zone – not only when compared to the United States, but also compared to what is happening inside large European economies. Let me mention what is under discussion in Europe in this respect.

When it comes to the financial markets channel, it would be helpful to complete banking union through a European Deposit Insurance Scheme, or EDIS. This is a controversial issue politically, because the current national systems are very different. Also, some countries would need to reduce legacy issues with their banks before an EDIS could be put in place. But it is a crucial step that will enhance confidence and thus strengthen monetary union.

Capital Markets Union is a more long-term project to enhance risk sharing through the financial market channel. Some of you may know from experience that bankruptcy, corporate and tax law vary widely across EU countries. Capital Markets Union strives to harmonize these laws to make it easier to invest across borders. This would help equity investment and venture capital. It would open up a new source of funding for small- and mid-sized companies, which are the backbone of the European economy. Thus, it would also reduce the dependence of the firms on bank loans.

Let me finally say a few words about increasing risk sharing through the fiscal channel. The EU budget has provided transfers to low-income countries in the EU for decades in order to promote real convergence in living standards. While the EU budget is small – a little over 1 percent of GDP - poorer countries can get support of up to 3 percent of their GDP, which is substantial. Monetary union does not need fiscal transfers in addition to that. However, it could be worth to set up an additional fiscal capacity for the euro zone for risk-sharing purposes. One idea is a rainy day fund, something that exists in most US states. Countries would get support from such a fund in bad times, and they would pay the money back once they recover. Another option is a centrally managed US-style unemployment fund countries would pay in to.

Another idea that has been floated to strengthen monetary union is that of a euro area finance minister. He or she could support policy coordination, external representation and visibility of EMU. And lastly, there is the idea of a European Monetary Fund. Some of these ideas are mutually exclusive, and it may take a while before they see the light of day. But they will make monetary union and the

European economy more robust. That means more wealth creation, more investment, and more jobs.

Ladies and gentlemen, I have painted a picture of Europe that is more nuanced than what you often read in the media. If I were to draw one lesson from the crisis, it is that Europe knows how to deal with one. You will no doubt discuss some of these thoughts at more length during the sessions. For instance tomorrow, during the session titled “More or Less Europe”. The title of the conference is very apt. We have indeed redesigned Europe in the past five years, and it has become much stronger as a result.

Europe will continue to take the steps that I have laid out. These steps – not big steps, but pragmatic ones - will strengthen monetary union. A strong Europe will benefit our citizens. And as a trusted trading partner and a valuable place to invest in, a strong Europe will also be to the benefit to the rest of the world.

Thank you for your attention.

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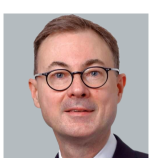

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