How to deepen Europe’s Economic and Monetary Union?

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24/01/2022
Speeches
ESM
Online
COE-klaus-1920-889

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“How to deepen Europe’s Economic and Monetary Union further?”
ESM Conference on the Future of Europe
Online, 24 January 2021

(Please check against delivery)

Good afternoon,

I warmly welcome you to this event, which represents the ESM’s contribution to the Conference on the Future of Europe.

The discussion on the future of Europe and our Economic and Monetary Union (EMU) is timely as we just celebrated the 20th anniversary of the introduction of euro banknotes and coins. Even though it is still a young currency, the euro quickly became the world’s second most important currency. Today, over 340 million European citizens use it every day across 19 countries, and with 78% of citizens supporting it, the euro’s popularity is at a historic high.

The last 20 years have also been a test of strength for the euro, during which it had to face numerous challenges – most notably the global financial crisis and the euro crisis. Member states have forcefully responded to these crises, and this also holds true for the latest major shock, the Covid -19 pandemic. A combination of existing instruments and new tools allowed the EU and the euro to weather this crisis. Now is a good moment to take stock of how far we have come but also to define a future agenda on what remains to be done.

Let me first look at the progress made so far.

Although the crises we experienced were challenges for the euro indeed, they were at least not wasted: They led to further progress on deepening EMU. The global financial crisis and the euro crisis spurred the launch of banking union, which notably brought the supervision of the most important financial institutions to the European level. The crisis also triggered the creation of a clear legislative framework for failing banks, with the aim to protect taxpayers’ money. The euro crisis also filled an institutional gap in the initial architecture of EMU. The temporary EFSF and then the permanent ESM became the lender of last resort for sovereigns in the euro area. Importantly, this also brought more risk-sharing within EMU.

More recently, the pandemic triggered a powerful European response to the economic consequences of Covid-19. The crisis response was well coordinated at both the national and the European levels. Countries that suffered most from the pandemic, received more financial assistance. This is in the interest of all Members of the single market and the monetary union and again, strengthens risk-sharing. Additionally, the experience of setting up the EFSF and ESM a decade ago was very useful for creating the "Next Generation EU" recovery fund by the European Commission.

As we now gradually emerge from the pandemic, it is important to reflect on how the agenda on deepening EMU further can be advanced and how we see the future of Europe. After all, the conferences on the future of Europe shall enable people across Europe to share their ideas and help shape our common future.

In this context, it is worth recalling and reviving some proposals already made back in 2015 by the so-called Five Presidents' report. I am referring to the idea of increasing risk-sharing in the euro area through the creation of a fiscal stabilisation function and the integration of the ESM into the EU framework.

In my view, those proposals are very relevant to foster the resilience of EMU. That's why they will be central in this conference.

Why do we need more risk-sharing in the euro area?

Risk-sharing in the euro area is the sum of mechanisms through which a shock – positive or negative – to a country's economy is transmitted to other member states. Risk-sharing supports convergence, avoids fragmentation, and helps smooth business cycles.

Compared to the US, economic risk-sharing between the member states of the euro area is relatively small. Therefore, shocks in the US are shared to a much larger degree than in the euro area. The same is true inside large euro area countries such as France and Germany, where risk-sharing is much better developed than in the euro area overall. It is estimated that 80% of local shocks remain "unsmoothed" in the euro area compared to 20% in the US. As a result, and compared to the US, business cycles diverge more, and fragmentation is a bigger risk.

Risk-sharing takes place through two channels: the public (or fiscal) and the private (or market) channel. Within countries (whether the US, France, or Germany) significant risk sharing takes place through a common tax and social security system. That cannot be replicated in EMU in the foreseeable future. Therefore, strong risk-sharing via markets is particularly important for the euro area. The more risk is shared through banks and markets, the fewer fiscal mechanisms are needed on the public side. As progress on banking union and capital markets union is slow, unfortunately, I will focus my remarks on fiscal mechanisms.

In the EU, public risk-sharing has happened for decades via the EU budget, lending by the European Investment Bank (EIB), and more recently through the support provided by the ESM and EFSF in critical moments. A common budget for financing common public goods, e.g. a common defence budget financed by common taxes, would be one way to enhance macroeconomic stabilisation in case of shocks but is not realistic any time soon.

Another way to strengthen public sector risk sharing of the euro area would be a central fiscal capacity for macroeconomic stabilisation. In a monetary union, the exchange rate and monetary policy cannot be used to respond to country-specific shocks. There is only one common monetary policy for all member states. Consequently, fiscal policy is the only macroeconomic policy instrument available to respond to country-specific shocks.

A euro area fiscal stabilisation function could make additional financial resources available to countries hit by a sizeable external shock if the national fiscal space turns out to be insufficient.

The pandemic has increased the urgency of establishing a central fiscal capacity. Considering the huge fiscal support in the last two years, some member states of the euro area may struggle to use their own national fiscal policy to respond to a new shock in the near future in light of high public debt. Looking beyond the short term, large asymmetric shocks could become more common if the occurrence of extreme natural events increases, because of climate change.

"Next Generation EU" was an efficient response to the pandemic. However, it is temporary in nature, it was appropriately designed for all EU countries and it is not predominantly an instrument for macroeconomic stabilisation purposes. It promotes structural reforms and provides financing irrespective of the position in the business cycle. For euro area members, it is worth analysing other instruments, in particular a permanent fiscal stabilisation mechanism.

Several proposals have been put forward and they would all help to strengthen risk-sharing: including re-insurance of national unemployment funds, rainy day funds and revolving funds including an ESM facility. They could all be designed to provide loans or grants or both. Although grants may have a stronger stabilisation effect, they could imply moral hazard concerns and, importantly, would require regular contributions from the budgets of member states.

Facilities based on low-interest loans are therefore easier to set up. The ESM could provide such a revolving fund that would provide loans to member states in a difficult economic situation. The ESM could draw on its existing lending capacity, no additional taxpayer money would be needed. In addition, the ESM could use its experience with sovereign lending. The different proposals made are not necessarily mutually exclusive; a revolving fund hosted by the ESM could complement other fiscal stabilisation mechanisms.

Proposals for increasing risk sharing – including through a euro area fiscal stabilisation facility, through banking union and a capital markets union – are today all controversial among the member states of the euro area. But they are important to promote the resilience of the euro area as well as convergence between its members. Progress on risk-sharing would also strengthen the international role of the euro. You will discuss risk-sharing in much more detail in Session II.

Let me conclude with a few thoughts on the second proposal of the Five Presidents' report and look at the possible integration of the ESM into the EU legal framework.

As you know, the ESM is an intergovernmental institution based on an international treaty. This set-up was unavoidable given the need to respond rapidly to the euro crisis. And it has worked well in practice, with excellent cooperation with our peer institutions, in particular the European Commission during programmes and post-programme monitoring.

The ESM's current governance arrangement is endowed with a democratic legitimacy from the national level. The ESM founding document was signed by the governments of the euro area countries and ratified in all parliaments. The Board of Governors, the ESM's highest decision-making body, consists of the 19 finance ministers of the euro area countries, who are accountable to their national parliaments. The capital behind the ESM – more than €700 billion – and therefore the risks taken by the ESM, are ultimately risks for national budgets. Yet, integrating the ESM into the legal framework would bring the ESM mandate closer to the European economic and fiscal policy coordination framework, and cooperation with EU institutions would become easier and more consistent.

A good model for the ESM inside the EU Treaty framework would be the European Investment Bank, which has its own protocol in the EU treaty. The EIB has similarities with the ESM – it also has its own capital, a governance structure with strong involvement of members states, and is, like the ESM, active on financial markets.

This model offers the best guarantee in terms of legal certainty, compared to other alternatives proposed in recent years, including the proposal to use secondary legislation for the integration of the ESM into the EU legal framework. We believe that an integration should only be done when the EU primary law is changed, i.e., an EU Treaty change at the next opportunity when the EU Treaties are reopened as part of a broader agenda, which might be one of the results of the Conference on the Future of Europe.

These series of conferences on the future of Europe are an excellent opportunity for us, for citizens, to present our vision on the different aspects of Europe and to build a future together. I hope the conference this afternoon, organised by ESM colleagues, can make a good contribution to this process.

I wish you a fruitful dialogue on the future of Europe with our distinguished speakers.

Thank you.

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