Klaus Regling in interview with Eurofi Magazine

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Interview with ESM Managing Director Klaus Regling Published in Eurofi Magazine, September 2022

Eurofi Magazine: What are the fiscal priorities to increase public risk sharing within the EMU and progress towards a Fiscal Union?

Klaus Regling: During the last decade, several crises have triggered significant institutional innovations which led to a deepening of our Economic and Monetary Union (EMU). This has strengthened the resilience of the euro area. However, more can be done to reduce vulnerabilities to future shocks further. More private and public risk sharing are essential in this respect.

Regarding public risk sharing, there is a need to establish a central fiscal stabilisation capacity. Such an instrument could enhance risk-sharing without creating permanent transfers or debt mutualisation. It would help the euro area cushion asymmetric shocks affecting one of its members, complementing national fiscal buffers.

At the same time, increased risk sharing should be accompanied by stronger incentives to comply with common rules and by enhanced monitoring of national fiscal policies. Agreement on a fiscal capacity could make up part of a package on a redesigned EU fiscal surveillance framework.

During the last 15 years, important steps have been taken towards a fiscal union. Although a full-fledged fiscal union is not realistic, and even not needed for a good functioning of EMU, the mentioned additional steps towards a fiscal union would be instrumental in making EMU more resilient.

What are the main priorities for progressing toward cross- border private risk sharing and encouraging an active and integrated banking and capital market in Europe?

To achieve a fully integrated banking system in the EU, where capital and liquidity can be allocated freely, thus creating strong risk sharing via markets, progress is needed on three fronts.

First, the European Deposit Insurance Scheme (EDIS). EDIS would remove the contingent liabilities of national governments that are currently backing national deposit guarantee funds. Setting up EDIS would bolster trust. Currently, different levels of protection at the national level means the euro does not have the same value across the euro area. This is not in line with the spirit of a monetary union.

Unfortunately, the introduction of a fully-fledged EDIS is unlikely to happen any time soon. Progress on EDIS is impeded by the unsolved debate among member countries on the regulatory treatment of banks’ sovereign exposures. The link between banks and sovereigns has been the subject of intense debate since the sovereign-debt crisis. The euro crisis has shown that this link can be a source of major instability. Banking union policies have addressed this link by mitigating the risks of a public bailout and protecting taxpayers from the cost of bank failures. The risk from sovereign to banks, however, should be addressed in a wider discussion on EU economic governance including fiscal rules and fiscal stabilisation.

Second, it is important to complete the second pilar of banking union by making the backstop effective. The ESM backstop provides a sizeable buffer for bank resolution (1% of covered deposits with a cap of €68 billion) and ensures their immediate availability. Whether called upon or not, this safeguard would reassure markets and considerably reduce the risk of contagion. It is operationally ready but requires the ratification of the amended ESM Treaty. Third, we need to limit ring-fencing policies. Ensuring an efficient allocation of liquidity and capital within banking groups is key. To reassure host countries, additional safeguards may be needed for banking groups with subsidiaries located in different member states. Purely contractual arrangements between the parent company and subsidiaries are not seen as sufficiently effective, as they may be difficult to enforce in time of crisis. To strengthen confidence, group recovery and resolution plans should be reinforced.

Progress is also needed to converge toward an integrated capital markets union. The limited size and liquidity of domestic markets constrain the availability of funding sources. Barriers to the free flow of capital between EU financial markets need to be reduced to ensure an efficient allocation of capital and limit market fragmentation.

Progress is needed in four areas.

First, a more unified markets regulation with a single rulebook for supervisory practices under the umbrella of the European Securities and Markets Authority (ESMA) could be a catalyst for a well-functioning capital markets union. The Single Supervisory Mechanism was a game changer for Banking union. ESMA could play a similar role in the de-fragmentation of European capital markets.

Second, the harmonisation of certain parts of the national insolvency proceedings would significantly improve the ability of financing parties to access effective and homogenous enforcement regimes. Enhancing legal certainty and making collateral recovery proceedings more predictable would enable investors to adequately price the risks and increase cross-border demand for securities in a genuine single capital market.

Third, to boost market size and liquidity, it is also necessary to simplify the taxation process. Divergent and lengthy refund procedures for taxes withheld in cases of cross-border investments are a strong deterrent to a single capital market. In addition, a tax-induced bias in favour of debt-financing instead of equity-financing not only leads European companies to rely mostly on banks for funding but might also incentivise too-high leverage and thus increase systemic risk.

Finally, a true single market cannot exist without a more integrated view of EU trading. Presently, investors face high costs to have full visibility of shares or bonds traded in different financial centres. Consolidated data on prices and volume of traded securities in the EU would improve overall price transparency across trading venues.

What are the key drivers to deliver European financial autonomy by the end of the decade? How to move forward?

Finalising banking union and establishing a capital markets union are the most important prerequisites for achieving European financial autonomy. This would strengthen the international role of the euro, which, conversely, would reduce reliance on other currencies. It would also help lower transaction costs.

Strengthening European financial market infrastructure is another important element. A case in point is central clearing. Clearing houses are key in ensuring market stability. However, a failure by the central counterparty due to a shock that exceeds its prefunded and callable resources could have systemic consequences. Brexit revealed the high dependence on extraterritorial service providers. Clearing of euro-denominated derivatives is still largely done from London.

Re-energising the European Payments Initiative would also be important. This private sector initiative to create a unified payment solution for European consumers and merchants has recently faced some headwinds as some banks withdrew from the project. The initiative’s core concept, to join forces to reach the necessary scale to offer competitive pan-European payment solutions and overcome national legacy payment systems and thus become a credible competitor to the major players, which are located outside the EU, is significant.

Finally, the creation of a digital euro, issued by the Eurosystem, would also strengthen monetary sovereignty and the role of the euro as a means of cross-border payments.

What should be the respective role of monetary policy and domestic fiscal and structural policies to address financial fragmentation in the euro area?

The mix of slower growth, tighter financial conditions, and elevated uncertainties risk increasing fragmentation within the euro area. Monetary policy instruments are in place to reduce fragmentation, which is imperative to ensure a good transmission of the single monetary policy. Credible and prudent fiscal policies also are fundamental to reduce fragmentation risks.

Currently, the euro area is facing different challenges than during the pandemic. When the pandemic hit, fiscal and monetary policy could act in sync, as inflation was low. Now, we are concomitantly facing an economic slowdown and high inflation. The risks of stagflation are real. While a tightening of monetary policy aims to bring inflation to its medium-term objective, fiscal policy needs to become more targeted.

Another vital component is economic growth. This is where the EU's economic recovery package comes into play. EU member countries have developed long-term plans for structural reforms to boost potential growth. These plans need to be implemented fully. Additional instruments, such as a fiscal stabilisation function, could also help increase fiscal buffers and alleviate pressure on monetary policy.

Finally, integrated capital markets would contribute to a better allocation of capital across the EU, which would promote potential growth and increase risk sharing via markets, which would reduce vulnerabilities and promote convergence.

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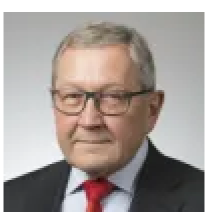

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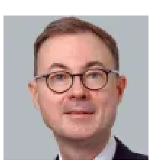

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