# “European Stability: Where do we stand and what’s in store?” - speech by Klaus Regling at Chatham House

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12/09/2017
Speeches
ESM
London, UK

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**Speech at Chatham House**
London, 12 September 2017

(*Please check against delivery*)

Ladies and gentlemen,

Many thanks for inviting me to talk about Europe today. The sessions at the Chatham House are always a pleasure, because of the high level of the debate. Not that everybody always agrees with what I say, of course. That certainly wasn’t the case when I was here 18 months ago. I presented an optimistic view about Europe, at a time when most media wanted you to believe that the next crisis was just around the corner. Whether it was the migration crisis, the rise of populist parties, Greece or the state of Europe’s banking industry, it all seemed bad news. That sentiment has now changed radically. Compared to the UK and the U.S., Europe has become a haven of political stability, and the economy is doing reasonably well.

I will make a few points to that effect in a moment. But I also want to look at what lies ahead of us. I expect that the outcome of the German elections this month will be supportive of Europe. This offers a good chance to further strengthen monetary union. The political debate about the next steps to make the euro area more robust has already begun. There is now a list of concrete measures Europe can adopt over the next few years. This list will be the subject of the second part of my introduction.

Let me begin with an oversight of the current economic and financial situation. The euro debt crisis is now well behind us, and Europe has come out of it stronger than before. The region has stronger institutions and economic governance. The euro area economic recovery is robust and well-synchronized. Per-capita growth is back in line again with that in the United States, as it was in the decades before the crisis. This shows that Europe’s capacity to create wealth for its citizens is as great again as that in the U.S. Europe’s headline growth rate is lower, but that is because of poor demographics.

Macroeconomic imbalances, which were a central reason for the euro crisis, have now been sharply reduced. Competitiveness has returned in many euro area countries, as nominal unit labour costs converged to more sustainable levels. Former programme countries in particular have made good progress in this area, often after years of unsustainable wage policies. As a result, the unsustainably high current account deficits from before the crisis have disappeared. To prevent such imbalances from building up in the future, Europe has put in place the Macroeconomic Imbalances Procedure.

Another strong point of the European economy is much better income distribution. This can for instance be measured by the GINI coefficient which ranges from 0 to 100, with the lower bound expressing perfect equality. In the U.S., it stands at 41, and in France and Germany around 30. Income equality continued to deteriorate in the U.S – and China – during the last decade but remained broadly stable in Europe. It is true that rising inequality is a problem throughout Western societies, but Europe’s starting position is far better. Our social model, with its strong safety net, is much better in dealing with negative side-effects of globalisation. I am convinced that this is helping to keep populism in check on the continent.

In labour markets, high unemployment remains a problem, particularly in countries such as Italy and Spain. It is a pressing issue for too many young people. What does not get enough attention to my mind however, is that the employment rate in Europe is higher today than in 2000, which means that a higher share of the population actually has a job than 16 years ago, despite the high unemployment rate. In America, the employment rate has dropped by more than 4 percentage points in that period.

Not everything is well, of course. Europe does need to address its low potential output growth rate. With our poor demographics, growth will mainly come from productivity gains. Structural reforms need to continue in all countries, not just in those who received an ESM assistance programme. Stronger investment would also help potential output growth. To offset poor demographics, Europe needs to increase the participation rate of women in the labour force, and raise the mandatory and effective retirement age for everybody.

In this context, countries should make every effort to integrate immigrants into the work force. Politically, this can be a thorny issue. Yet without immigration, the population of countries such as Germany and Austria would already be shrinking.

Another gap that the euro area needs to fill is economic risk-sharing, which is underdeveloped compared to the U.S., but also to large member states such as Germany. Both fiscal and private market channels for economic risk sharing need to be widened. I will talk about ways how this can be achieved in a moment.

Looking at the fiscal side, the overall picture is favourable. Debt is decreasing. The euro area debt-to-GDP ratio stood at 91 percent last year, and is projected to continue to drop, while the U.S. debt ratio is above 100% and rising. Public deficits have shrunk after the crisis, and converged to a narrow range. The aggregate fiscal deficit of the euro area is much better than that of the UK, the U.S., or Japan. Importantly, this gives the region more fiscal space should the next crisis hit. Furthermore, high debt levels in former programme countries are helped by the favourable lending terms of the ESM.

When looking at the financial sector, European banks have strongly recovered after the crisis, in line with banks in other regions. Capital has doubled, and profitability is improving, though it is clearly below the levels in the U.S. Through Banking Union, important powers have been transferred to the European from the national level. With the Single Supervisory Mechanism, day-to-day oversight of the 130 most critical bank now takes place centrally. And the Single Resolution Board is a new institution to wind down failing banks.

Non-performing loans have been gradually coming down from a peak in 2013, and are well-provisioned. Still, they are clearly too high, particularly in some countries. This means the financial sector is less efficient than could be wished for. This is probably one of the reasons why euro area financial integration is well below its peak from just before the crisis. And this in turn stands in the way of economic risk-sharing via financial and capital markets. Non-performing loans need to decrease further. To that end, euro area ministers adopted an action plan in July.

Now let me turn to my second “chapter”, and look at the reform agenda that lies ahead of us to deepen monetary union further, to make it more robust and more resilient.

First, Banking Union should be completed by setting up a backstop for the Single Resolution Fund. A European Deposit Insurance Scheme, will also need to be put in place, though this will only happen once countries have sorted out legacy problems.

Capital Markets Union, a comprehensive harmonisation of bankruptcy, corporate and tax law would make it easier to invest across borders. This would open new ways for companies to fund themselves and help reduce Europe’s dependence on bank financing. The completion of Banking Union and the Capital Markets Union would increase risk-sharing within the monetary union.

The euro area also needs to make progress in the way it runs fiscal policy. The fiscal rules were tightened after the crisis, but are now too complex, and hard to understand. So it is good to see that efforts to simplify the rules are now under debate.

It is also important to say what we do not need, in my view, to make monetary union work better. We do not need full fiscal union, nor a specific facility for symmetric shocks, or additional transfers between countries. The existing EU budget already allows for sufficient transfers from rich to poor countries, which can amount to 4 percent of the receiving country’s economy. Full political union is not required either for a smoothly functioning monetary union.

But we do have to take some other steps. A mechanism to counter asymmetric shocks, in my view, is an important gap in the euro area’s fiscal tools. A discussion about a limited fiscal capacity that would fulfil this function has begun. This would form an important new fiscal channel for economic risk-sharing. The tool can be designed without debt mutualisation, and without permanent transfers between countries. In this context we could look at examples that exist in the U.S., for instance rainy day funds, or a complementary unemployment scheme.

A European Monetary Fund is another idea to improve euro area economic governance. It is unlikely that the IMF will participate in any future euro area assistance packages, at least financially. And so, many people have suggested that the ESM could be developed into an EMF, something that is now subject to political debate.

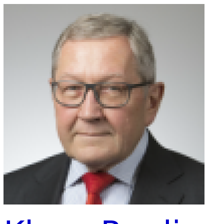
In the longer run, the euro area could also develop a European safe asset, but that requires some debt mutualisation, which cannot happen unless there is a lot more confidence that all euro area countries comply with the rules they have agreed to.

Ladies and gentlemen, I am often asked if monetary union is ready for the next crisis. My answer is: yes, but it could still be stronger. A lot of hard work has been done after the crisis. The remaining steps that I have sketched are modest, but would bring tangible benefits. Politically, there is a growing probability that the members of the euro area can agree on them in the foreseeable future. This is because of the strength of the economy, and because of the pro-European outcome of recent national elections.

The popularity of the euro is at its highest level since 2004. This shows that citizens have understood the benefits of monetary union very well. It is also a strong mandate for politicians to continue to work on making monetary union more robust.

Thank you, and I am now ready for your questions.

## Author



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