“The ESM after 5 years: successes, challenges and perspectives” - speech by Klaus Regling

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“The ESM after 5 years: successes, challenges and perspectives”
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(*Please check against delivery*)

Ladies and gentlemen,

The day that the ESM opened for business is now a bit more than five years ago. I came to Luxembourg earlier: in 2010, when the EFSF, the temporary predecessor of the ESM, began its work.

I have always found it was the right decision to locate the EFSF and the ESM in this country. We are surrounded by many important European institutions in Kirchberg. It is impressive to see that a small country is home to such a big number of European bodies.

The Bridge Forum Dialogue is an excellent platform to meet the neighbours, and to talk about European integration. We are very happy to be a member of the club.

A lot has happened in the past five years. But the ESM is still a lean organisation. That was the goal from the beginning: to be a modern public sector institution, not a large bureaucracy.

Almost 180 people work for the ESM. That is still a modest number, if you think of the amounts of money we handle.

This small group of people is very diverse. Our staff comes from 43 countries. People from as far as China and Australia have found their way to Luxembourg. This is important for the global market activities of the ESM, and another impressive feat for the country.

Of course, it wasn’t always like that. I remember the first days of the EFSF very well. On day one, we were with three people. And we still only had eight people in January 2011, when we issued our first bond to finance the programme for Ireland.

One of the first things we did was buy a coffee machine. It still works. I keep it near my office.

Jeroen will talk about the future of the ESM, and the planned euro area reforms. So let me look at what happened after those first moments of the EFSF, in the middle of the crisis.

Looking back, one has to remember that Europe did not go through just one crisis in the last decade, but two. First, there was the global financial crisis, which originated in the U.S. subprime mortgage market.

It affected the entire world, including European banks, particularly after the collapse of the U.S. investment bank Lehman Brothers in September of 2008. But then, Europe entered another crisis, the euro debt crisis. This was entirely of our own making.

A number of countries lost the confidence of investors, and were shut out from markets. This was because of unsustainable economic policies that had led to a loss in competitiveness, unsustainable fiscal deficits and, in some cases, huge real estate bubbles. Contagion and typical herd behaviour in markets aggravated the situation.

As a result, governments could no longer refinance themselves in the bond market. This could have led to their default and possibly to their departure from the euro area.

In 2010, the euro area first organised a package of bilateral loans to Greece, and later that year, established the temporary EFSF. The ESM followed in 2012. It is a permanent institution, based on an intergovernmental treaty between the euro area countries.

But the creation of the EFSF and ESM was not the only important step that Europe took. Let me briefly describe the comprehensive strategy that was put in place to fight the crisis.

The most important step was that countries did their homework, and tackled the problems that had led to the loss in market access.

They tightened budget policies, implemented structural reforms, and restored competitiveness. As a result, the macroeconomic imbalances that were a main cause for the euro crisis were sharply reduced.

Competitiveness converged across the euro area. All programme countries reduced unit labour costs, in some cases by cutting wages, salaries and pensions by up to 20 or 30 percent, through what is known as internal devaluations. As a result, the unsustainably high current account deficits from before the crisis have disappeared.

The overall fiscal picture is also favourable. Public deficits have shrunk, and converged to a narrow range. The euro area fiscal deficit is around one percent of GDP this year, and debt is decreasing.

The euro area debt-to-GDP ratio stood at 91 percent last year, and is projected to continue to drop in the coming years. It is now much lower than in the U.S. or Japan. This gives the region more fiscal policy space than other economies, if the next crisis hits.

Progress was also made at the European level. Economic surveillance was broadened beyond the fiscal side. The new Macroeconomic Imbalances Procedure will help the Commission to detect and warn of early signs that a next crisis could be building up.

The ECB also played a crucial role in fighting the crisis, through its unorthodox policy measures, which were in line with those of other central banks in the world. This is perhaps best remembered through Mario Draghi's "whatever it takes" speech of July 2012. This was essential to turn market perceptions around.

Next, Europe made important progress through the Banking Union. With the Single Supervisory Mechanism, there is now a central supervisor for the 130 largest banks, while the Single Resolution Board is Europe's new cross-border authority to resolve banks. By setting up these two bodies, countries have transferred significant national powers to the European level. This is one reason why the financial sector in the region is now much safer.

The final element of Europe's comprehensive crisis response – after national reforms, better economic policy coordination, ECB policy and Banking Union – was the creation of the rescue funds.

The EFSF and the ESM are new additions to the institutional architecture of the monetary union. It is our role to provide financial assistance to euro area countries that lose market access during a crisis.

We are, in other words, the lender of last resort for sovereigns in the euro area. That function did not exist before the crisis. When the Maastricht Treaty was signed, people thought it was impossible for a country to lose market access once it had entered the monetary union. And yet, this is exactly what happened between 2010 and 2012. As a consequence, countries such as Greece, Ireland or Portugal could have been forced to leave the euro area, which would have worsened the crisis even further.

Since 2011, the EFSF and ESM have provided loans to five countries: Greece, Ireland, Portugal, Spain and Cyprus. In total, we have disbursed €273 billion in loans, 2.5 times as much as the IMF globally in the same time period. The ESM has a paid-in capital of €80 billion, the highest of any international financial institution.

The ESM does not spend any taxpayer money to finance its assistance programmes. Instead, we raise money from investors by issuing bonds and bills. We can do this at very favourable rates.

This is because of our high credit rating, based on the ESM's high paid-in capital and the EFSF's strong guarantees. Programme countries realise considerable budget savings because of our low rates. The interest payments they make to the ESM are the same as those we pay in the market, and well below what the countries would be charged by investors. In the case of Greece, this saves the country's budget almost €10 billion per year, or 5.6 percent of GDP. These are very substantial amounts. And so, euro area countries provide solidarity without spending any public means.

In order to qualify for such advantageous loans, countries must fix their problems, and commit to strict economic reform programmes. This typically means reducing public deficits, restoring competitiveness, and repairing the banking sector. Needless to say, such reforms initially are always painful for the population. Lowering pensions and wages, and cutting government support programmes understandably will meet resistance. But such measures are unavoidable if income increases had been far above productivity gains, and if fiscal deficits are excessive. In the long run, citizens will enjoy stronger economic results.

Of the five ESM programme countries, four are success stories now. Ireland, Spain, Portugal and Cyprus ended their programmes after three years and are doing well. Ireland is growing by around 5 percent, and Spain and Cyprus by around 3 percent. This makes them euro area growth champions. These countries are also reform champions, according to the World Bank and the OECD. The structural changes they have implemented will form the basis for their future success.
Greece is the only country that is still in an active ESM programme. It is now in its seventh and final year, and the government is on the right track to implement the reforms that it committed to in the summer of 2015. If Greece continues to implement the agreed reforms, chances are good that it can regularly refinance itself after completing the programme in August next year.

Already, it made a first few steps in that direction, by accessing the bond market in July and with a highly successful bond exchange the last few days. Euro area governments have promised to provide further debt relief at the end of the programme, if needed, and if Greece continues to implement the reforms.

So much about Europe’s comprehensive policy response to the crisis. These measures have made Europe stronger than it was before: economically and institutionally. In the final part of my remarks, let me give some evidence of the strengths of the economy.

The recovery that started in 2015 has accelerated recently. Confidence among consumers and businesses is at the highest level since the start of the crisis. The recovery is also well-synchronised, with each euro area country growing.
A point that is often forgotten is that Europe’s capacity to create wealth for its citizens is as great as that in the U.S. This can be seen from per-capita growth, which is back in line again with that in the U.S. This was the case for decades, but the relationship was disrupted during the crisis. Europe’s headline growth rate is often lower, but that is because we have lower population growth and lower birth rates than in America. At the moment, per-capita growth is actually higher than in the U.S., though this difference will eventually disappear when our output gap has closed.

Another strong point of the European economy is much better income distribution than in the rest of the world. Income equality continued to deteriorate in the U.S and China during the last decade, but remained broadly stable in Europe. Europe’s social model has a strong safety net for those who need it. This offers superior support to those struggling to cope with the rapid changes that globalisation can bring. This should help to keep populism in check.

In labour markets, high unemployment remains a problem, particularly in some countries such as Greece and Spain. It is a pressing issue for too many young people. But what does not get enough attention to my mind, is that the employment rate in Europe is higher today than in 2000. This means that a higher share of the population actually has a job than 17 years ago, despite the high unemployment rate. In America, the employment rate has dropped by more than 4 percentage points in that period.

These strong points should not hide the fact that there are also a number of weakness in the European economy – some structural, some a legacy from the crisis. Examples are the low potential growth rate and low profitability in the banking sector, which is still weighed down by high levels of non-performing loans. Another issue is the lack of economic risk sharing between the countries of the euro area, which is underdeveloped when compared to the U.S. This makes Europe more vulnerable to shocks, and is a particularly pressing issue at a time that the U.S. administration is questioning multilateralism, and that the relative economic importance of Europe in the world continues to decline.

Addressing these challenges is high on the political agenda. I'm very happy that I can now hand the floor to the President of the Eurogroup, who will look into the future and give his views on how Europe can respond to the challenges it is facing.

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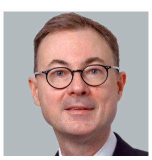

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